

Enhancing Equity Returns

The Case for Adding Small Buyouts to a Portfolio

Key Takeaways

1. Small buyout investments are an important component to endowment-style investing and have generated excess returns for investors over the past twenty years
2. We believe small buyout markets are less dependent on macroeconomic forces like interest rates or the direction of public equity markets making them a diversifying source of absolute returns
3. Investing in small buyouts takes a unique skillset and a team with deep networks and insight in the space – not only to identify opportunities, but also to offer support to managers as a business and strategic partner

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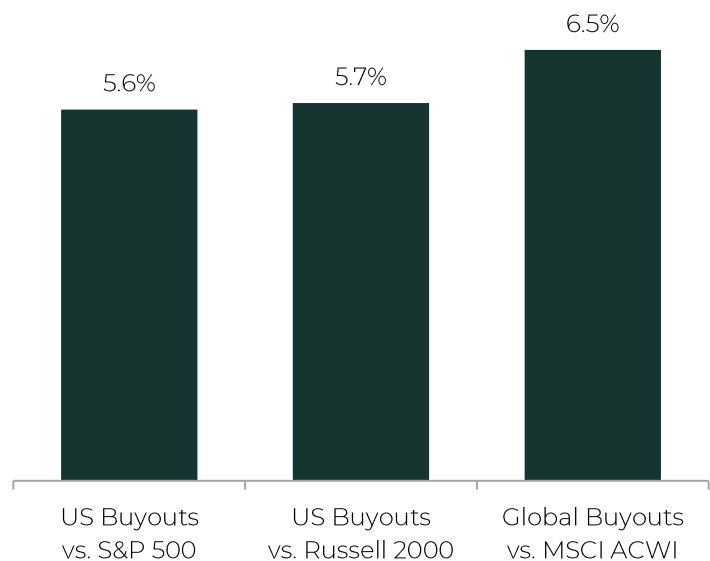
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Overview

Equity is a key component of most investment portfolios and comes in many forms. With variations from passive investments via broad stock indices to actively managed portfolios by professional investors, implementation is critical. According to Standard & Poor's (S&P), the median domestic equity fund has beaten US stocks in only six of the last twenty years.¹

The question to ask is: how can investors position portfolios to deliver durable equity returns over the long term? At GEM, we believe working with a broad palette of equity alternatives is additive to portfolios because it widens the opportunity set for investors. Specifically, adding small leveraged buyouts to investor portfolios has generated excess returns over the past twenty years.

Table 1: Public Market Equivalent Annualized Excess Return of Small Buyouts vs. Public Indices



Source: Burgiss; buyout vintages 2000-2019 for 20-year period ended 12/31/21

¹Source: S&P Global, [SPIVA US Year-End 2021](#).

We define small buyout managers as those targeting businesses with less than \$25 million of EBITDA and fund sizes below \$1 billion. According to Burgiss², the US small buyout industry overall has generated 5.6% annualized excess returns vs. the S&P 500 over the past twenty years. However, selection can make a meaningful difference; top quartile buyout managers have generated 9.9% excess returns while bottom quartile buyout managers have underperformed the public markets by 4.4%. With that kind of dispersion of results, skilled selection in finding managers that can excel is critical.

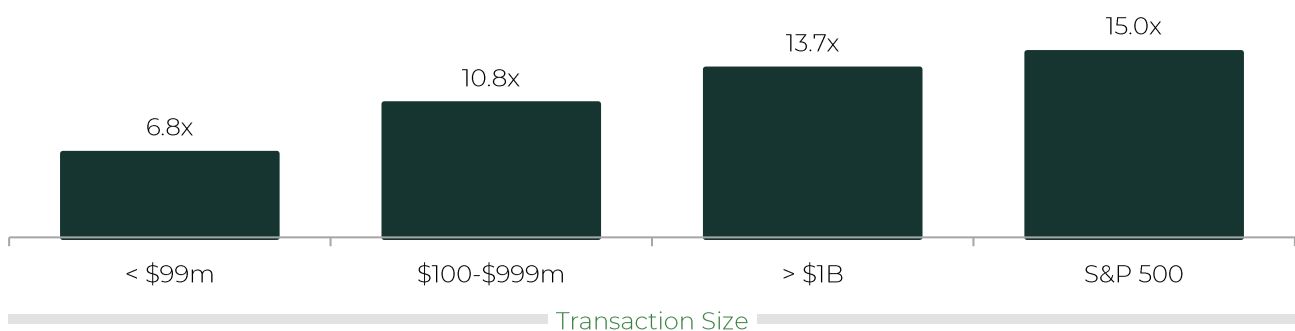
The Role of Small Buyouts in a Portfolio

Buyout or leveraged buyout (“LBO”) managers purchase controlling or significant minority stakes in private companies. The typical LBO target is a mature business with a consistent operating history and cash flow, making them prime candidates for leverage. While it is true that buyout managers benefit from markets with low interest rates (leverage is cheaper and plentiful) and from higher valuations in public equity markets (their most common path for company exits), the manager also has direct control over the company’s destiny, which can be an enormous advantage over public markets. If they believe company management is doing a poor job, they can change the leadership team. They can stomach a short-term hit to earnings without having to explain it to public market analysts. David Swensen, the late CIO of Yale University’s Endowment, referred to buyout investing as a “superior form of capitalism.”³ This element of control has been a key driver of buyout outperformance, and as a result, many buyout managers have invested in bringing operating experience and/or in-house teams to support portfolio companies.

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The buyout industry operates in a predictable food chain. Small buyout managers buy small companies with the goal of transforming them into institutionalized businesses for sale to larger buyout managers. These large buyout managers further grow the businesses and eventually sell to even larger buyout managers or to public markets through an initial public offering. As shown below, businesses generally become more expensive as they mature and move up the food chain.

Table 2: Valuation Multiples by Company Size for US Buyouts vs S&P 500
EV/EBITDA by Transaction Size as of 12/31/21



² The Burgiss Manager Universe covers 12,000 private capital funds with data sourced exclusively from Limited Partners





³ <https://www.cfr.org/event/conversation-david-swensen>

We believe the small buyout opportunity set is an attractive area for a few reasons:

1. Generally, the purchase prices are lower than larger buyouts or public stocks. The reward for successfully executing a transformation is a significant step up in the exit multiple, which is a key contributor to outsized returns.
2. The target companies generally have considerable room for operating improvements and for growing earnings.
3. Typical leverage of 3x to 4x EBITDA is lower than larger buyout opportunities, which reduces risk.

Points 1 and 2 above provide a simple formula for small buyout managers – buy low, fix up, sell high. Point 3 implies a return profile that is less sensitive to interest rates and more dependent upon the manager’s execution abilities. Below we show an illustration of a typical small buyout opportunity.

Table 3: Anatomy of an Investment

	STEP 1	STEP 2	STEP 3	STEP 4	STEP 5
	Buy a business	Improve operations	Expand distribution	Professionalize team	Sell higher quality, larger platform
					1+1=3
	Pet food manufacturer with \$5M EBITDA	Improve procurement & reduce waste for \$1M EBITDA	Added 3 new retailers for 15% rev. growth over 3 years	Add a CFO, replace CEO for larger businesses	Ideally sell to a strategic or larger buyout firm
CUMULATIVE EBITDA (\$M)	\$5	\$6	\$9	\$8	↑ 60%
VALUATION MULTIPLE	7x	7x	8x	10x	↑ 3x
DEBT (\$M)	\$20	→ PAY DOWN DEBT W/ CASH FLOW GENERATED →			↓ \$5
EQUITY (\$M)	\$15	→ 5X RETURN →			\$75

Finding the Right Partners

Large investment consultants and money managers often require a three-fund track record to invest with a private manager. The reason is simple – a long, clearly attributable track record is the easiest way to assess investment manager skill. However, at GEM we believe this rule can lead to missed opportunities for institutions with the resources to look beyond a formal track record.

Our team believes the best way to access the small buyout market is by backing managers early – often on Fund 1, Fund 2, or even on a pre-fund basis (what we call Independent Sponsors). We believe the best returns often occur earlier in a fund manager’s career before the market catches on and floods the

manager with capital. Our experience has shown that the best small buyout managers typically grow into middle-market managers by their third or fourth fund.

Finding a manager early doesn't mean they are inexperienced. We look for managers with significant experience as a 'deal lead' at another buyout firm. We call these situations "Fund 1 on the cover but Fund 3 in their career" and find these managers have the right mix of experience and hunger.

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Finding these managers requires a skilled team to identify, filter, and underwrite each opportunity. The conversation typically begins with managers before they have left their prior firm to start their own. There are often no formal marketing materials (and certainly no three-fund track record!), so there is an extensive amount of work involved to reconstruct their prior body of work, including references with portfolio company CEOs and prior colleagues, among others. There's also an array of challenging administrative set-up issues to contend with that they have likely never addressed before. For these new managers, finding the right investor from the outset who can provide guidance, resources, and most importantly, capital, can make the initial business launch faster and more successful, allowing them to focus on what they do best: delivering returns to their investors.

Case Studies

To illustrate, we'll close with two examples of small buyout opportunities sourced by our investment team. What you'll see in both is us looking to leverage our deep insight into the market and the individual managers to predict who will be the next great buyout manager. Our goal is to identify them before the rest of the market does.

Bringing Big Firm Resources to an Underdeveloped Market

In 2016 we connected with a rising star that was a former employee at a successful large buyout manager. The prior firm had grown AUM considerably and abandoned the small buyout market, so the former employee was looking to set up a new firm to target those attractive opportunities. We spent the next 18 months doing our due diligence and acting as a sounding board for their ideas on strategy, team, and structure. They exhibited everything we like about small buyouts, bringing their big firm resources and ideas to a less competitive part of the market.

Strategy:
Corporate carve-outs

Geography:
United States

Fund Size:
\$42.5 million

Manager background: Seasoned investment principal with a strong track record from a well-known large buyout firm

Sourcing: Introduced through an existing manager who was a former colleague / mentor

Merits: Creative deal structures with meaningful downside protection, non-economic sellers, focus on quick return of equity capital, targeting high returns

Other investors: None

Global Manager Ready to Spread His Wings

In 2018 the head of the European team at a well-known global buyout firm was considering launching his own firm. He was ready to execute on attractive investment opportunities he was seeing in the market. We spent two years partnering with him on his ideas and were his first institutional commitment. Without the prior knowledge of who he was and his capabilities, we wouldn't have had the opportunity. We believe his firm will be a successful story when the fund comes to fruition, and we aren't alone. The founder of his predecessor firm invested personally as well.

Strategy:

Lower middle market
buy-and-build

Geography:

Central & N. Europe

Fund Size:

€250 million

Manager background: Head of European office within global buyout firm

Sourcing: Connected via mutual connection and built relationship for four years prior to launch of new firm

Merits: Unique operational transformation capabilities, less competitive lower middle market, talented and hungry manager

Other investors: Large private foundation, non-profit health system, family office of prior firm's founder

Not all small buyout opportunities will look like these, but most share common traits that we believe can lead to outperformance in the long-term. Those traits are: lower relative purchase prices at entry, opportunities for the manager to create value through operational improvements, and fund sizes / structures that align the manager with investors. Executing this strategy can be time- and resource-intensive, but we believe the potential excess returns make it worthwhile.

About GEM

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For more information, visit <https://www.geminvestments.com/>.



Endnotes

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