Smaller buyouts outperforming their larger cousins, but riskier, says new research by Pantheon

By Paul Bryant

"We had a hunch that small and mid-cap managers had more 'juice to squeeze' from their deals and deliver higher returns than large-cap managers. But we didn't have hard evidence to back that view up," says Dr Andrea Carnelli Dompé, vice president at Pantheon, an investor with USD46 billion of assets under management in private equity, infrastructure and real assets.

"As we already had an extensive database of deal data, it just made sense to review that critically, and test to see if our hunch was right."

Pantheon analysed 2,237 buyout deals from around the world, executed by GPs between 2000 and 2012 (excluding post-2012 deals ensured all deals studied were mature enough to provide reliable data). Smaller deals, or 'small and mid market buyouts' (SMBO) were classified as having an entry Enterprise Value (EV) of below USD500 million, while deals with entry EVs above that were termed 'large and mega buyouts' (LMBO).

The results of the analysis, presented in the September 2019 paper, *Do Small and Mid-Market Buyouts Outperform?* revealed that on average, the compounded annual growth rate (CAGR) of Total Value to Paid In (TVPI) on SMBOs was 5 per cent higher than on LMBOs.

SMBOs delivered positive returns in every vintage year except 2000, including those years heavily affected by the financial crisis, while LMBOs suffered negative returns in four vintage years – 2000, 2006, 2007 and 2008.

The difference in performance, Pantheon suggests, is that SMBO managers have more levers of value creation at their disposal.

More scope for operational improvements

The most important and most interesting lever, says Carnelli, is the greater opportunity for operational improvements in SMBOs compared to LMBOs.

Operational improvements have become more of a focus across the PE size spectrum over the last few decades. Research by the Boston Consulting Group revealed that the share of value creation attributed to operational improvements in 1980s PE deals was just 18 per cent. In 2012, it had risen to 48 per cent.

However, as Carnelli states:, "In our experience, SMBO deals tend to be in companies that have fewer resources, less experienced management and more inefficient processes. As a rule, when they grow, there is more budget to hire better managers; more professionalisation of the management; and more attention paid to how processes are run. So from a PE perspective, it clearly makes more sense to get in before these efficiencies have been captured."

He continues: "What we then see is that PE managers take a stake in these smaller companies and help with implementing best practice across operations – 'gold standards' they have seen elsewhere; they place a huge emphasis on strengthening the board and governance; they recruit higher-calibre managers; and they leverage their network to source new suppliers and customers. It is also common for PE managers to introduce sector experts – either as consultants for shorter-term projects, or as operational partners, present for the life-cycle of the deal."

Carnelli says that while operational improvements can be a value creation lever in large deals as well, because much of the efficiency gains would have already taken place, it is not as powerful as in smaller deals.

Another factor in favour of superior SMBO returns, says Carnelli, is the likelihood that these deals benefit more from the now common PE strategy of 'buy and build',where a PE manager buys a platform company. This becomes the focal point of acquisition deal activity, often at quite low entry valuations, integrating each new acquisition onto the platform before selling the combined entity after exploiting synergies and scale, for a potentially higher multiple.

He explains: "Both SMBO and LMBO managers pursue buy and build strategies, but it is a more common strategy in the SMBO space, and there is probably more scope to make many smaller acquisitions that can have a positive impact on the business. LMBO buy and builds are under much more pressure to search for the perfect add-on of sufficient size that can impact a large business."

More deals to choose from

A second source of SMBO outperformance, says Carnelli, is that smaller and mid-market managers simply have more opportunities to choose from. Pitchbook data shows that in the US and Europe, sub USD500 million deals have made up around 80 per cent of all deals by number over the last few years.

In its 2018 Crystal Ball Survey, Pitchbook found that PE managers are worried about having access to a sufficient number of quality opportunities, noting: "Respondents ranked 'high transaction multiples' and 'deal sourcing/lack of quality assets in the market' as the most important challenges for PE dealmakers in 2018."

The larger universe of smaller deals allows SMBO managers to look more widely for interesting deals, adopt sector-focused investment strategies more often than in LMBOs, and perhaps be a little pickier in their selection criteria. Carnelli says: "In an increasingly competitive private equity environment, a manager's ability to demonstrate deep expertise in a focused field has become a key differentiating factor for some GPs, and such specialism seems to be bearing fruit."

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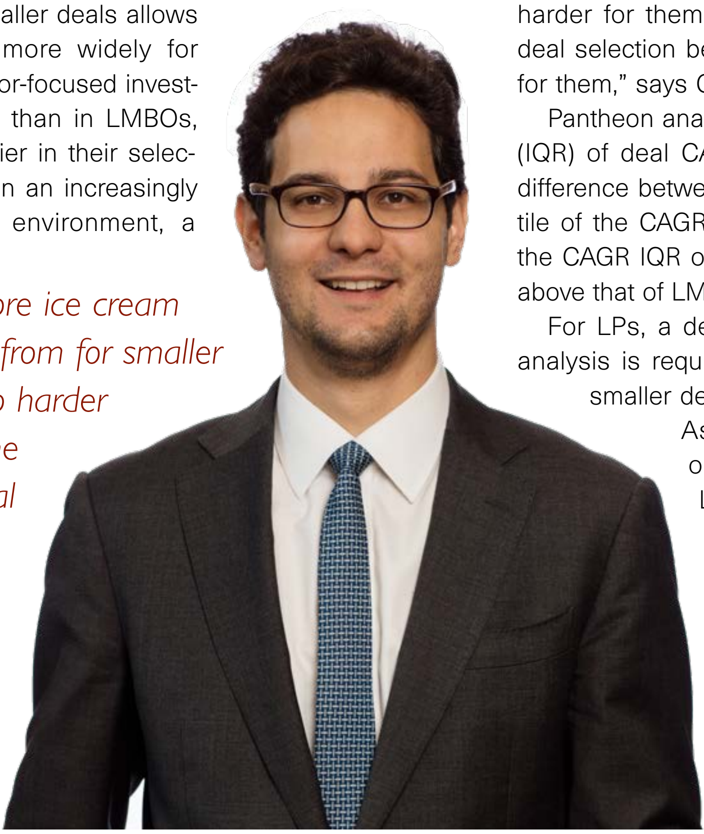
Dr Andrea Carnelli Dompé, Pantheon



More attractive valuation metrics

A final source of outperformance comes from entry multiples' being lower for SMBOs, which offers more opportunity for 'multiple-expansion' at exit.

Pantheon's report shows that for small and mid cap companies, the average EV/EBITDA multiple of sub USD100 million deals between 2013 and 2017 was just over nine, while for deals over USD1 billion, it was nearly 13.

"As small and mid-market companies expand under PE ownership and become larger companies," says Carnelli, "their multiples increase, providing SMBO managers with more scope for value accretion. The (already high) entry multiples of LMBO deals makes the task for those managers much harder."

However, the performance of SMBO deals, while superior on average, has also been more dispersed than LMBO deals. There are more underperforming SMBO deals as well as more high performers. This could expose investors to greater risk.

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Pantheon analysed the inter-quartile ranges (IQR) of deal CAGRs by vintage (IQR is the difference between the 75th and 25th percentile of the CAGR distribution), and found that the CAGR IQR of SMBO deals is consistently above that of LMBOs (often double the range).

For LPs, a degree of caution and greater analysis is required before rushing in to the smaller deal space.

As Pantheon suggests: "In order to harvest performance, LPs need more fund selection skills in SMBO portfolios than in LMBO portfolios of similar size. As a consequence, in order to obtain attractive risk-adjusted performance in the SMBO space, disciplined manager selection and portfolio construction are imperative." ■