Growth Equity in the Lower Middle Market

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**Purpose**

The purpose of this paper is to illustrate the benefits of combining the growth equity style of investing with a focus on lower middle market (LMM) companies. We examine this from the perspective of Limited Partner investors and General Partner fund managers.

We wrote this white paper for two main reasons:

1) Growth equity seems to be the least understood of the private equity investing styles as compared to venture capital and leveraged buyout.

2) While there are some publically available reports on the merits of investing in lower middle market sized companies and others on growth equity, we believe this is the first whitepaper to study the combination of the two.

In addition, we believe this is the first whitepaper to compile the aggregate long-term returns of lower middle market growth equity funds and compare them to other private equity funds. We partnered with PitchBook Data, Inc. to perform the long-term returns analysis and discuss the methodology and criteria in Section 4, “Long Term Returns.”
1. Growth Equity

Private equity as an asset class can be broken down into three main categories:

- Venture capital (VC)
- Growth equity
- Leveraged buyout (LBO)

Growth equity investors generally focus on the middle stage of a company’s life cycle when revenue is established and growing, as shown below.

![Figure 1: Growth Equity in the Company Life Cycle](image)

Growth equity investing is a hybrid of the venture capital and leveraged buyout investing styles and by design, attempts to reduce some of the risks of the other two strategies. The following compares key attributes of the three main private equity investing styles:

![Figure 2: Attributes of the three main PE investing styles](image)
Venture Capital:

The key attributes of venture capital include investing in companies with developing products/services and low revenue (or sometimes no revenue). Early-stage companies are typically cash flow negative until they generate enough revenue to support their business costs and growth rate. With negative cash flow these companies are usually unable to support traditional debt service.

The growth equity investing style reduces the early-stage company risk associated with the venture capital investing style by focusing on companies:

- With established products/services
- Which are growing revenue
- With positive cash flow

While venture capital investors help develop ideas into new businesses, growth equity investors focus on established businesses and how to drive their revenue growth. By steering clear of companies that are cash flow negative, growth equity investors can avoid additional investment rounds that are dilutive to shareholders.

Leveraged Buyout:

Typically, LBO investments are made in businesses with established cash flow when the company’s products/services are mature and stable. At this point, revenue growth has usually begun to slow down or in some cases, either flattened out or even started to decline. To generate returns in businesses with these characteristics, LBO investors use “financial engineering,” meaning they put debt on the business and then try to pay that debt off as fast as possible using the cash flow from the business. In this way they can generate returns without necessarily having to grow revenue.

Financial engineering can work well for mature businesses that do not have significant revenue growth (and where growth equity investing would not be applicable). However, there is some degree of risk created by adding debt to the business, also called adding “leverage.” The degree of that risk is based on how much debt is added relative to what the business can comfortably support. A high level of debt relative to what the business can support means little margin for error if things do not go according to plan.

Growth equity investing attempts to reduce debt risk associated with LBO investing by focusing on revenue growth as a way of generating returns and using no leverage, or moderate leverage relative to what the business can comfortably support.
SUMMARY: Growth equity investing is a hybrid of the venture capital and leveraged buyout investing styles and can reduce some of the risks associated with the other two investing styles.

2. Lower Middle Market

Lower middle market (LMM) companies are those between approximately $10 and $100 million in revenue. The following subsections highlight the advantages to investors who focus on the lower middle market.

The Lower Middle Market is the Largest Segment of the Market

In the United States, 90% of companies have between $10 and $100 million in revenue, which is how we define the lower middle market. Even for growth equity investors who are interested in cash flow positive companies, there are plenty of LMM investment opportunities to choose from. There are over 125,000 companies globally with less than $100 million in revenue and positive EBITDA. In the U.S. alone there are over 32,000 companies that fit the same criteria.

The Lower Middle Market has become More Inefficient For Growth Equity

The lower middle market has become more inefficient for growth equity in the last 15 years for two main reasons:

- There has been a decrease in small-company IPOs
- Small growth equity financing rounds are lacking representation by investment banks

Decrease in Small-Company IPOs:

There are fewer small-company Initial Public Offerings (IPOs) today than 15 years ago as the following graph shows.
Sarbanes Oxley is certainly a significant contributing factor but another is the economic incentive for investment banks to focus on small-company IPOs has decreased. Co-managers receive a smaller percentage of the economics in an IPO than they did 15 years ago. Investment banks such as the “Four Horseman” (Alex Brown, Hambrecht and Quist, Montgomery Securities, and Robertson Stephens) which focused on small-company IPOs in the 1980’s and 1990’s, no longer exist. As small-company IPOs have decreased, time to IPO has increased. This has created a greater opportunity for growth equity investors.

**Small Growth Equity Financing Rounds are Lacking Representation by Investment Banks:**

As discussed above, the 1980’s and 1990’s had investment banks focused on small growth IPOs. In addition to taking companies public, investment bankers would help companies raise small growth equity financing rounds. This was a way for investment bankers to develop relationships with company management teams with the hope of lucrative IPO fees (or other fees) in the future. With the absence of a small-growth IPO market today, investment bankers do not have the incentive to spend time working on small growth equity financing rounds so they are spending their time on M&A deals, IPOs, and other financings that generate larger fees.

Fewer investment bankers representing small growth equity financing rounds is a contributing factor in the lower middle market becoming even more inefficient than it was 15 years ago. Fortunately, for growth equity investors this has created more opportunities to invest in LMM companies without investment bankers creating auctions to drive up valuations.

**Alignment of LP & GP Interests**

Because of the size of the companies they invest in, lower middle market funds are relatively small in size. In smaller private equity funds there is a stronger alignment of interests between Limited Partner investors and General Partner fund managers than there is in larger private equity funds.

Smaller private equity firms generate lower management fees per General Partner than larger funds, so the fund managers of small PE funds depend more on investment performance, than on management fees, to create personal wealth. In LMM funds this creates a strong alignment of interests between the Limited Partner investors and General Partner fund managers, who have significant “skin in the game” and depend on driving fund performance for personal wealth creation.

**SUMMARY:** The lower middle market is attractive because it has more companies than any other segment, has become more inefficient in the last 15 years, and there is a strong alignment of interests between Limited Partner investors and General Partner fund managers.
3. Growth Equity in the Lower Middle Market

In Section 3, we will discuss how the combination of the growth equity style of investing with a focus on lower middle market sized companies can be powerful for investors for a number of reasons.

Small Companies Tend to Grow Faster

The majority of the fastest-growing companies in the U.S. are in the lower middle market. Because small companies have a lower denominator to start with (relative to large companies) their growth rates can be much higher than those of a large company. The pie chart in Figure 4 shows the U.S. companies that are growing revenue by 25%. Of those companies, 68% are lower middle market sized companies, meaning they have between $10 and $100 million of revenue.

![Figure 4: Percentage of U.S. companies growing at 25% YoY Revenue](image)

More Opportunities to Add Value and Increase Growth Rates

Growth equity investors partner with management teams to help them expand their businesses. This not only includes investing capital but also bringing growth expertise to the board of directors, management team, and the company. Typically, growth equity investors focus on sectors where they have past investing experience and/or operating experience (managing a business).

Often LMM companies lack the best processes and teams to optimize operations or financing capabilities. For growth equity investors focused on LMM companies, this is an opportunity to add value through:

- **Human Capital Expertise**: Growth equity stage companies may have experienced people in some positions but can be missing key personnel who enable significant business growth—a CFO, COO, or key technical person. Because growth equity investors specialize in specific business sectors (technology, healthcare, etc.) they can draw on their past experience and
business network to help company management teams identify and fill critical employee positions.

- **Financial Expertise**: Because growth equity investors focus on companies that are profitable and positioning themselves for significant growth, they have encountered many of the financial challenges specific to companies of similar size and stage. Growth equity investors can help company CFOs and financial executives address those challenges by advising them and/or connecting them with financial resources and mentors.

- **Exit Expertise**: Growth equity investors have experience with the many different types of exit realizations that are available and can help management teams:
  a) Identify the exit opportunities that are most appropriate
  b) Plan for exit opportunities well in advance to position the company for success

**Valuation Multiple Expansion Magnifies Returns**

By investing in LMM companies, growth equity investors can increase business valuations not only by growing revenue and improving margins but also by benefiting from valuation multiple expansion, which is simply that buyers (or investors) pay higher purchase price multiples for larger companies. The following shows the average purchase price multiples (EV/EBITDA) paid for companies of different sizes (Enterprise Value) on average over the last 10 years (2002 to 2012).

![Figure 5: Valuation (EV/EBITDA) Multiple Expansion](image)
Investors in the LMM (<$100 million in enterprise value) paid 6.5x EV/EBITDA while investors in larger businesses paid higher EV/EBITDA purchase price multiples.

Growth equity investors benefit from valuation multiple expansion by investing at purchase price multiples in the LMM and selling at relatively higher multiples. The effect of valuation multiple expansion compounds on revenue growth and margin improvements. Most importantly, it can help growth equity investors magnify their returns.

Contributing factors for why valuation multiple expansion exists in the private equity market are the following:

1. Buyers (or investors) are willing to pay higher valuations for larger companies because the work of growing them to that point has been done.
2. Larger companies are typically more stable and that makes more debt available to them.
3. Investment bankers create auctions for larger companies and that drives up valuations.

More Exit Options

For growth equity investors in LMM companies there are more exit options than there are for investors in large companies. The key reasons for this are the following:

1. There are more acquisitions of smaller companies than acquisitions of larger companies. In fact, 94% of acquisitions done in the U.S. are at an enterprise value of less than $250 million\textsuperscript{11}.
2. Small, fast-growing companies can be attractive targets for both:
   a. Strategic company acquirers; and
   b. Large private equity firms.
3. The IPO market is an exit opportunity for small growth companies as well (although it takes longer to get to an IPO than it did 15 years ago, as discussed in section 2).

In contrast, exit opportunities for large companies are limited to the IPO market or an acquisition or merger with another large firm. However, only 6% of the acquisitions done in the U.S. are at enterprise values over $250 million\textsuperscript{11} so there are not that many large company acquisitions or mergers.

SUMMARY: Combining the growth equity style of investing with a focus on the lower middle market can be effective for investors because of the following reasons: small companies tend to grow faster; more opportunities to add value; valuation multiple expansion magnifies returns; and more exit options.
4. Long-Term Returns

Methodology

Part of the purpose of this whitepaper was to analyze the long term returns of lower middle market growth equity funds as compared to other private equity funds. Our goals in classifying a data set were to: 1) identify funds that most practitioners would agree fit the definition of “lower middle market growth equity”; and 2) have a data set that was large and robust enough. We partnered with PitchBook Data, Inc. to analyze the long term returns of lower middle market growth equity funds and compare those aggregate returns to other private equity investing styles. PitchBook Data, Inc. performed the long-term returns analysis and the data are from PitchBook Data, Inc’s database.

Based on the methodology discussed above, the long-term returns (10-Year Net IRRs) for venture capital, all private equity funds, lower middle market buyout funds, and lower middle market growth equity funds are as follows:

![10-Year Net IRR graph]

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>10-Year Net IRR (period ending Q3 2013)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Venture Capital</td>
<td>0.0%</td>
</tr>
<tr>
<td>All PE Funds*</td>
<td>5.0%</td>
</tr>
<tr>
<td>LMM Buyout Funds</td>
<td>10.0%</td>
</tr>
<tr>
<td>LMM Growth Equity Funds</td>
<td>15.0%</td>
</tr>
</tbody>
</table>

*Defined as Buyout, Mezzanine, Energy, Growth, and Venture

Figure 6: Growth Equity Internal Rate of Return (IRR) 12

Long-term returns for LMM growth equity funds have outperformed LMM buyout funds, venture capital funds and the private equity industry as whole.

The key criteria PitchBook Data, Inc. used to define the sample data set were the following:

- The time period for the 10-year Net IRR was 2Q 2003 to 2Q 2013;
- Lower middle market funds (both growth equity and buyout) defined as those with under $750 million in capital commitments;
• Growth equity funds, leveraged buyout funds, and venture capital funds were those labeled as such in PitchBook Data, Inc.’s database; and
• The private equity industry as a whole included the growth equity funds, leveraged buyout funds, venture capital funds, mezzanine funds and energy funds labeled as such in PitchBook Data, Inc.’s database. The number of funds in the data set for Venture Capital, All PE Funds, LMM Buyout Funds and LMM Growth Equity Funds are 144, 386, 82 and 27, respectively.

Conclusion

The growth equity style of investing in private equity can lower risks relative to venture capital and leveraged buyout styles. The lower middle market is attractive for investors who focus there for a number of reasons. Furthermore, the combination of growth equity with a focus on the lower middle market offers significant advantages to both Limited Partner investors and General Partner fund managers.
Sources


[2] 2007 U.S. Census (includes all firms public and private) and Camden Partners Analysis.


[12] PitchBook Data, Inc. 2014; 10-year Net IRR is for the period from 2Q 2003 to 2Q 2013; Growth Fund as defined by PitchBook Data, Inc.; Lower Middle Market defined by PitchBook Data, Inc. as funds with under $750 million in capital commitments.

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