Private Equity
Small is Beautiful

FOCUS ON SMALL PRIVATE EQUITY COMPANIES

Kempen

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Private Equity: Small is Beautiful

Much of what we consume today, be it goods or services, is developed, produced and delivered by small and medium sized companies. In fact, according to Eurostat, the overwhelming majority (99.8 %) of enterprises active within the EU are small and medium sized companies, some 23.3 million. Together they account for two out of every three jobs and for 57.4 % of value added within the economy[1].

There are various ways to define small and medium size companies (i.e. by enterprise value, number of employees or sales/turnover). Generally it is market practice within the private equity market to make the classification by enterprise value. Most private equity market participants define companies with an enterprise value of more than €500m as large buyout companies. Companies with enterprise values between €250m to €500m are defined as upper mid-market companies. Companies with enterprise values of €100m to €250m, as the core mid-market and companies between €50m to €100m as lower mid-market. Small Cap private equity companies are defined as companies with enterprise values up to €50m[2].

We have summarized this in the table below.

SEGMENT	*COMPANY ENTERPRISE VALUES*
× Large buyout companies	€500m and up
× Upper mid-market companies	€250m to €500m
× Core mid-market	€100m to €250m
× Lower mid-market	€50m to €100m
× Small Cap private equity companies	Up to €50m

Small Buyout

Going forward in this paper we will take small and lower mid-market category together (all companies with enterprise value up to €100m) and for ease of reading we will refer to this category as small (private equity) buyout companies. These small companies, with an enterprise value up to €100m, are a key contributor to the overall economy, according to the figures published by the European Commission[3]. Moreover, all successful large-cap companies that are around today, have spent much of their existence as fast growing small companies. Consequently, many investors may be keen to tap into the growth potential at the smaller end of the market.

1 *Eurostat (European Commission), Key Figures on Europe, 2017 edition*
2 *European Private Equity and Venture Capital Association (2018)*
3 *Eurostat (European Commission), Key Figures on Europe, 2017 edition*

However, accessing these opportunities has historically been a challenge. Such companies are typically not listed on public stock exchanges and the information available on them is much more challenging to acquire. Therefore, investing with private equity specialists who focus on the small buyout market can potentially be an attractive way of gaining access to the potential returns that this segment offers. However as many of these specialist operate 'under-the-radar', they are themselves also more difficult to find. Additionally, these private equity specialists tend to have limited capacity in their funds[4] and they are extremely capital disciplined as they avoid attracting too much capital. Therefore this segment is difficult to access, even (especially) for larger institutional investors such as pension funds and sovereign wealth funds, as they simply have too much money to put to work in private equity.

This paper aims to shed more light on how and why to access the potentially attractive small cap private equity market.

Breadth of Opportunity

The private equity small cap market is vast, with a considerable range of potential investment opportunities. According to Eurostat, the EU has around 230,000 investable companies specifically in this segment, and this number gets larger every year. The UK has 27,000 investable small cap companies, Germany ca.60,000 and for instance the Benelux has almost 13,000 such companies[5].

The number of buyouts completed at less than €500 million in enterprise value is more than five times the number of deals above €500 million[6]. Within that group, the number of small cap buyouts (enterprise values of up to €100mln) completed is even 15 times the number of deals above the €100 million threshold. This has consistently been the case for the last ten years and we believe it is unlikely to change in the future.

What's interesting is that these companies are often still being run by the founding families and they have not had any institutional or private equity owners up till now. In our experience, there is a lot of potential for further growth through professionalization, digitalization, operational efficiency and internationalization, as we will describe later in this paper. Also, founders increasingly are faced with succession challenges, which creates investment opportunities, especially considering the increasing ageing of our European population. In addition, these companies often have many opportunities to expand into new markets/product lines, while conglomerates, by their nature, will continually provide spinout opportunities.

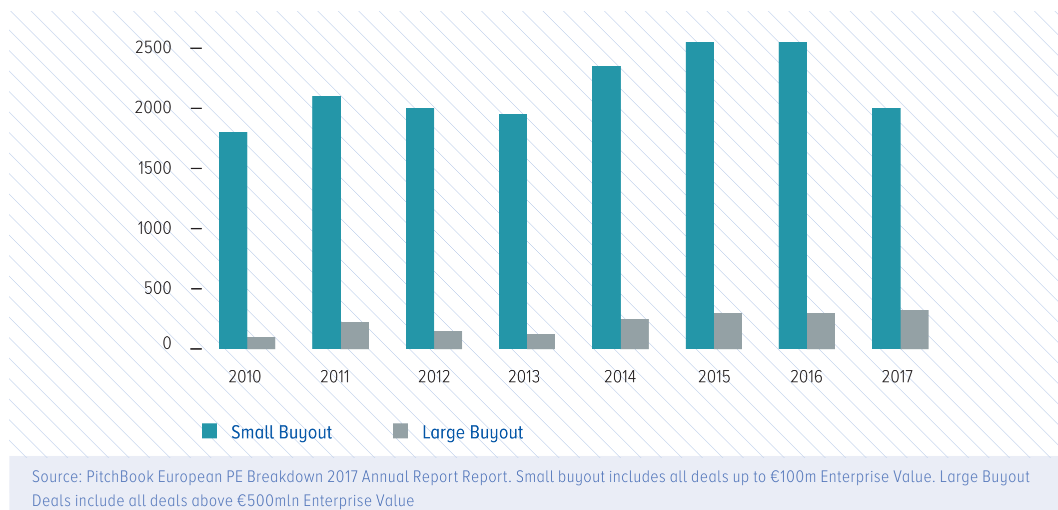
4 *The definition of small buyout funds are all funds with total committed capital less than $500m, according to data provider Preqin. These are the smallest private equity funds. Mid-market buyout funds have AUM of $500m to $1.5bn and large buyout funds are defined by Preqin as funds with AUM of more than $1.5bn.*

5 *Eurostat (2015) ttps://ec.europa.eu/eurostat/tgm/refreshTableAction.do;jsessionid=4ypr4UBN1TKAzSbXoeOwJBp_nNr1nFE1qF63K42AniElZYcfSP-mR!-389200218?tab=table&plugin=1&pcode=tin00145&language=en*

6 *PitchBook. Data as at November 2018.*

With such a broad and diverse universe, there are clearly a large number of companies with substantial growth potential, but which are currently not well known among investors – the difficulty, of course, is finding them.

FIGURE 1: Number of European Private Equity Deals by Transaction Size in Euro



Source: PitchBook European PE Breakdown 2017 Annual Report Report. Small buyout includes all deals up to €100m Enterprise Value. Large Buyout Deals include all deals above €500mln Enterprise Value

Less Dry Powder

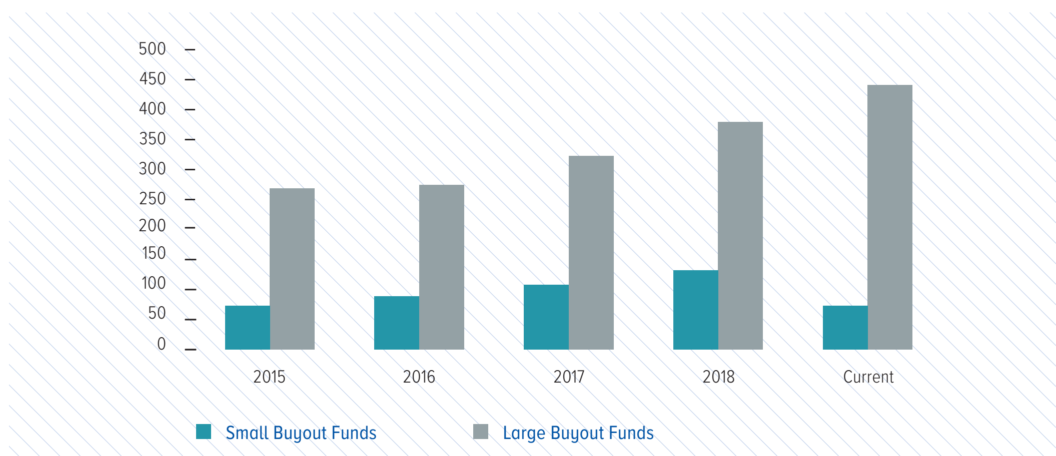
There are currently record amounts of committed but not yet invested capital ('dry powder') in the overall private equity market, driven mostly by record fundraising of larger funds[7]. We note that record amounts of capital have flown to almost every risk-bearing asset class in the last few years, simply as a result of the search for yield. We also note that the private equity market has grown over time and the dry powder as percentage of the invested capital has actually shrunk dramatically over the last decade[8].

While the full-year fundraising total for private equity in 2018 is not as high as in 2017, the pace is still on par with activity seen in 2015 and 2016. Moreover, it is increasingly being concentrated among a small number of large private equity buyout funds. This is a trend we have noted before, but it is accelerating according to Preqin. To illustrate, the ten largest funds closed in Q3 have secured a combined $66bn, which is a record breaking 55% of the total capital raised by the entire private equity industry[9].

7 *Preqin Q3 2018 Fundraising Update*
8 *Preqin Private Equity dry powder figures as of January 2019*
9 *Preqin Q3 2018 Fundraising Update*

For small buyout funds[10], dry powder has been growing at a slower pace than the rest of the market over the last three years[11]). With less dry powder, the demand-supply dynamics remain relatively favorable at the lower end of the market; the vast number of small cap opportunities is more than sufficient to absorb the capital available, in our view.

FIGURE 2: Dry Powder in private equity buyout funds, in Billion Euro's



Source: Preqin, figures as of June 2018

Note: Buyout funds only. Preqin defines small buyout funds as all funds with AUM below $500m. In our experience the funds in this segment typically invest in companies with enterprise values not larger than €100m (i.e. small buyout companies in terms of enterprise values) . As such one could roughly say that this segment of buyout funds are focused on small companies exactly how we define it. Large buyout funds are defined by Preqin as funds with AUM of $1.5bn and above. Source: Preqin, figures as of June 2018.

We note that the chart above includes buyout funds across all regions, so this does not represent just Europe. However based on our analysis of Preqin data, we see that the amount of dry powder in the US has consistently been twice as large as the amount of dry powder available in the European market in the last five years[12].

Attractive Valuations

In private equity deals, the valuation of a company is usually determined by putting a multiple on the company's EBITDA[13] as a guideline for buying an interest in the company. This multiple to EBITDA varies over time. On a multiple to EBITDA basis, small cap companies in Europe that are purchased by private equity funds tend to have significantly lower entry valuations than large-cap companies. Also, the entry deal multiple valuations tend to be more stable over time on the lower end of the market, while large deals tend to move more in line

10 *Source: Preqin (funds up to $500m in size).*

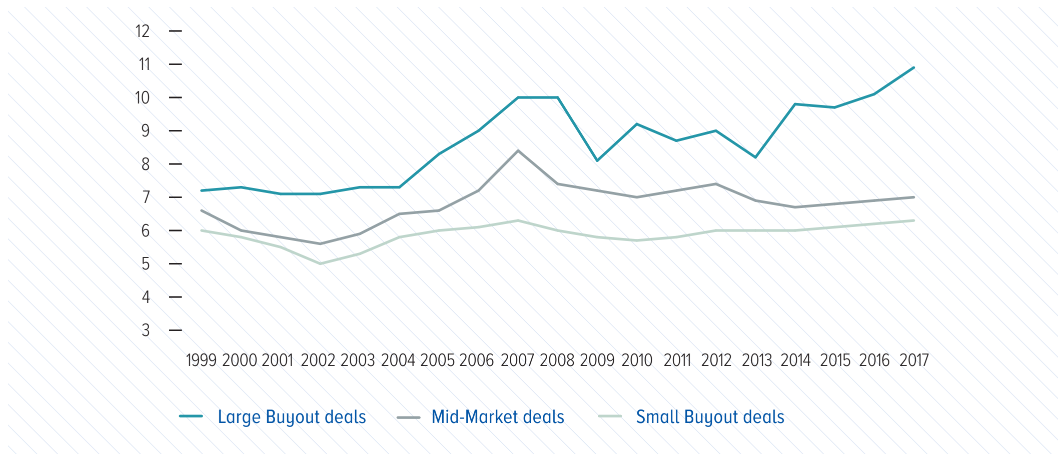
11 *Source: Preqin, as of June 2018.*

12 *Preqin Private Equity dry powder figures as of January 2019*

13 *EBITDA stands for 'Earnings Before Interest, Taxes, Depreciation and Amortization' and is a measure of the gross profit minus the overhead costs of a company. It is widely used as a measure of the gross profit that a company achieves with its operational activities without the costs and revenues of the financing being deducted yet.*

with the stock market and the availability of debt. Interestingly, the gap between the valuations of large vs. small cap company transactions has widened over the last five years, as can be seen in the graph below.

FIGURE 3: Average historical purchase multiple (Enterprise Value to EBITDA)



Source: PitchBook 2017 Global PE Deal Multiples, December 2017 & Kempen January 2018[14]

We note that these are just averages with outliers on the upside and on the downside, and while there are differences by company, it also largely depends on the sector. For instance healthcare companies and fast growing IT companies tend to transact at higher valuations than typical 'old fashioned' industrial companies. However we do subscribe to the general conclusion that smaller deals generally have lower valuations. We have drawn a dotted line for the average historical purchase multiple of specifically the small buyout deals which over time moves closely around the 6x EBITDA[15].

Risks of smaller companies

The difference in valuation can partly be explained by the fact that smaller companies are considered to be riskier, for example because these companies have a more limited and less diversified income stream. It is also often suggested that smaller companies have less experienced or less senior management teams. In addition, the balance sheets of smaller companies may have less strong assets, which could possibly be sold in the event of a restructuring. Finally, an argument for a higher risk and / or a lower valuation is the fact that smaller companies are simply managed less efficiently. However, in practice this is not always the case for all small companies and in our opinion a potentially higher risk only explains part of the valuation difference.

14 Large Buyout deals include all companies with enterprise values above €500m. Mid-market deals include all companies with enterprise values between €500m to €100m. Smalll buyout deals are all deals up to €100m. We note that we do not have full data for 2018 yet.

15 Please note that the details of smaller deals are often not reported in any databases so there is no independently evidenced average historical figure available in the market. however based on our own experience, doing due diligence on the historical entry deal valuations of dozens of small & lower mid-market private equity funds across Europa that are focused on this segment of the market we see this as a good proxy.

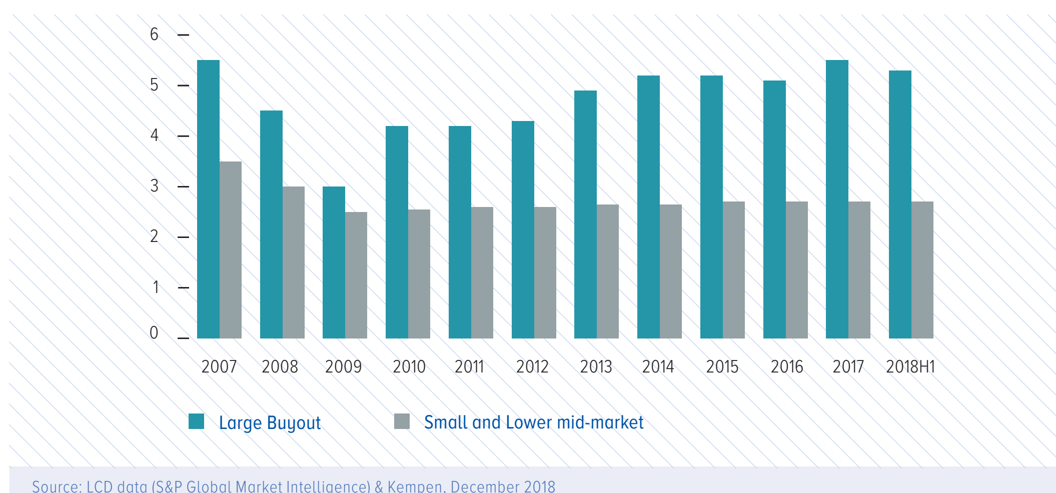
With more available dry powder in large buyout funds and a much more narrow universe of potential deals to focus on, competition for deals at the large end of the market has become more and more intense. Additionally, larger deals almost without exception are being intermediated by financial advisers. These advisers often organize competitive auctions to sell these companies to maximize the potential price. This has put upward pressure on deal valuations.

Rather than through competitive auctions, small buyout deals are typically sourced by smaller private equity firms through proprietary networks, where local knowledge and relationships are key. A company owner, often still the founding family, often puts more weight in factors such as the culture and strategy of a new buyer, given that the business may have either been within the family for generations or is an important employer in the local community. As a result, the transaction price is often not the only consideration and as such is not maximized in terms of enterprise value to EBITDA. In practice the original owners roll forward (re-invest) a significant portion of the transaction proceeds into the company. The existing management teams in most cases also buy into the companies with their own capital. This provides some comfort that the valuations are more reasonable and alignment of interest is embedded.

Small Companies Use Less Leverage Than Larger Firms

Small buyout companies have historically carried significantly less leverage (as measured in a multiple to EBITDA basis) than large buyout companies[16], as both banks and small buyout private equity funds tend to be more prudent towards the use of debt for smaller companies.

FIGURE 4: Average historical Debt-to-EBITDA ratio for Small vs. Large buyout companies



Source: LCD data (S&P Global Market Intelligence) & Kempen, December 2018

16 *Source: LCD data (S&P Global Market Intelligence) & Kempen, December 2018*

When measured differently, for example in terms of debt to total capital, we see the same picture. Small buyout companies often operate in a range of 30-40% loan-to-value, while large buyout deals typically have more than 50% leverage.

The lower leverage multiples of smaller companies mean that they have a sufficient equity buffer in case of difficult times. This is especially important when investing in private equity late cycle. Additionally, lower leverage and simpler capital structures allow for the use of preferred equity instruments and/or shareholder loans. It is market practice within small buyout that transactions are structured using these instruments. This provide a bit of downside protection while preserving a significant part of the upside potential of the investment. The minority equity investment of for instance the management team (in case of an management buyout or management buy-in) or the founding family then ranks below the preferred equity of the private equity investor, which provides a buffer in case of an underperformance. This lower leverage and typical deal structure using preferred equity instruments next to standard equity is also one of the reasons that small buyout private equity is not necessarily more risky than investing in large buyout private equity.

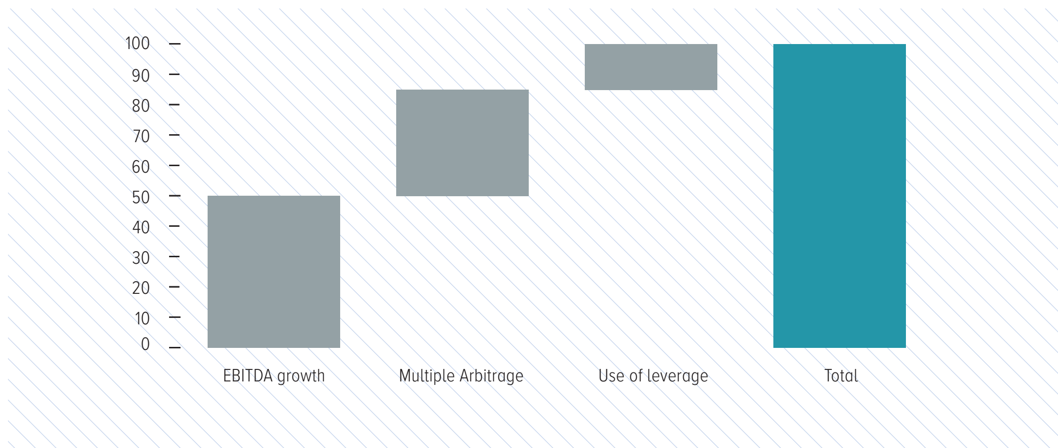
Value Creation instead of Financial Engineering

Since private equity investors in small companies do not rely on leverage to drive returns, investors are focused to create 'true' value, predominantly through business growth and operational improvements. Based on an analysis of the value-creation of the historical investments of the small buyout private equity partners we have worked with for many years, approximately half of the value creation in private equity companies was driven by EBITDA growth. A further 35% was driven by multiple arbitrage (selling at a higher multiple vs. the entry multiple), while only 15% came from the use of leverage[17]. For large companies, in our experience the majority of value creation came from the use of leverage[18], while most of the EBITDA growth came from cost cutting and operational efficiencies and less from organic growth.

17 *Analysis done by KCM per December 2018. We note that this is a specific dataset of private equity managers we have done due diligence on and that this may not be true for the broader market and that this may also be different going forward.*

18 *i.e. profiting from cheap debt and the fact that interest rates are tax deductible*

FIGURE 5: Average historical sources of value-creation for Small buyout (Kempen subset)



Source: Kempen, December 2018. We note that this is a specific dataset of private equity managers we have done due diligence on and that this may not be true for the broader market.

While in our experience large buyout private equity often invests in companies that previously have had an private equity owner or otherwise an financial-driven sponsor, which often means 'the lemon has been squeezed' already and the potential for value creation is generally more limited. Small buyout companies often still have much low hanging fruit to reap. Firstly, there is typically scope to professionalize a small company by upgrading its management team, for instance by hiring an chairman with experience in the specific sector the company is active in. Typically private equity may discuss with the management team to get to a clear-cut strategy and helping them to develop a decent business plan for the next several years based on ambitious but attainable targets. It may also prove useful to hire a dedicated experienced Chief Financial Officer to get more transparency on the financial reporting and to get more grip on where the company costs are spent and where the margins are earned. This will help effect change in areas such as improving sales efficiency, finding new markets or launching new products, ultimately seeking to develop growth opportunities and improve overall efficiency for the company.

In addition, strong private equity firms will have networks of professionals and operating partners they have worked with before, and who can be brought in to help execute on the agreed upon business plans.

Organic growth or Buy-and-Build?

Driving organic growth typically is one of the main pillars of value creation in this segment of the private equity market. We already described a couple of ways to attain this goal, but more specifically often we see internationalization/geographic expansion, digitalization or process improvements as main way to drive organic growth of the company. Additionally, the ongoing consolidation process in a number of industries offers strong potential to add value by enabling companies to acquire growth and benefit from cost synergies. Small companies are also generally able to follow a buy-and-build strategy, whereby competitors are acquired and integrated, without encountering problems with competition authorities.

Last but not least, typically a next buyer pays a premium for a well-run company that is more mature and has grown in size. Thus, properly executed operational improvements should result in value creation through revenue growth, EBITDA growth and multiple arbitrage.

Outperformance of the Small Buyout Market

The proof of the pudding is in the eating, and the result of the above factors have historically led to better returns for small private equity funds relative to larger buyout funds. This is shown by independent third party research[19], as well as by our own research, which we present below.

We have used the Preqin database for our research, which is a widely used institutional database for benchmarking historical private equity performance numbers[20]. We have split the data for historical performance numbers of all small buyout funds (all funds with AUM less than $500m[21]) and larger funds (all funds with AUM larger than $500m). Also, we looked at all vintage years[22] of the past 30 years, more specifically 1985 to 2014, but we note that there are not many historical data points in the period 1985 to 1995. We disregarded the funds with vintage years after 2014, since the percentage of capital that has been drawn and invested generally still is very small for these funds and therefore it's simply too early to calculate these funds' performance numbers sensibly. In total we analyzed 1763 private equity funds and our sample, compiled as described above, contained 1013 small buyout funds and 750 larger funds with a significantly long track record[23].

Our research shows that on average, the IRR of small buyout funds amounted to 18% net after costs per annum as measured over the historical period, while the average IRR of larger funds amounted to 14.5% net after costs over the same period. Looking only at European funds, the numbers are largely the same 18.5% net IRR on average for small buyout funds versus 15.4% net IRR for larger funds[24].

Furthermore, interesting takeaways may be found when looking at the so called 'quartiles'. Isolating the 25% top performing small European buyout funds, and calculating the average performance generated by these funds over the period, we get to a very significant net IRR of 47% per annum. Doing the same exercise for the

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19 *A research study conducted by European Private Equity and Venture Capital Association in December 2012 based on Thomson Reuters data shows a large outperformance of small buyout versus the broader private equity market. The research was based on the pooled average IRR of European private equity funds net of fees since inception for funds with vintage years 1990-2011.*

20 *Like all databases, the data is never complete and the data in the Preqin database also has some biases. However we note that Preqin collects data not just from private equity funds/General Partners ('GPs') themselves, as that would lead to self-reporting bias, they also collect data directly from private equity investors, so-called Limited Partners ('LP's), and they make an appeal on the 'freedom of information act' to get historical performance data for instance from US and UK based pension funds to complete the dataset.*

21 *We note that Preqin has put the cut-off at $500m and not at €500m as the US Dollar is their base currency.*

22 *The vintage year is the year in which a private equity fund has made its first investment*

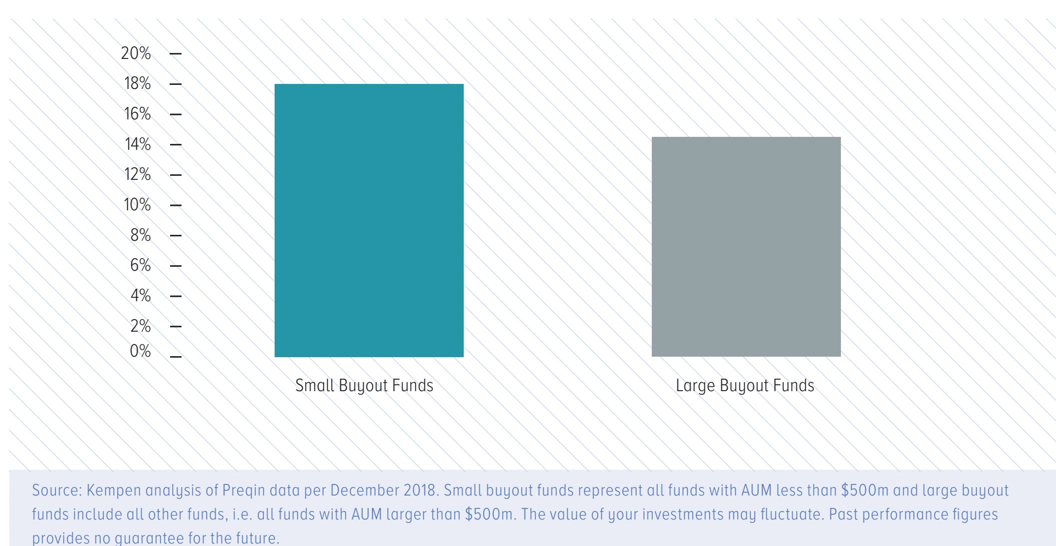
23 *The precise method to get the data was as follows: Within the Preqin private equity database, 'advanced search' was selected. The following filters were applied: Vintage (All to 2014), Investment Type: Buyout, and for the European analysis we also added the filter for Geography/Fund Focus (Europe). We broke the data in two: The first one with funds smaller than $500m, and the second for the rest.*

24 *The performance is measured in US Dollar, as this is the reporting base currency of the Preqin database. The value of your investments may fluctuate. Past performance figures provide no guarantee for the future.*

larger European buyout funds over the same time period, we find a more limited, but still respectable historical net IRR of 31% per annum. Of course we note that these are historical average returns and this gives no guarantee for the future.

Doing a similar calculation as the one in the previous section but then for the bottom 25% funds in terms of performance, we get to 4.3% performance per annum on average for small European buyout funds, as opposed to 3.9% per annum on average for larger funds. This shows that the downside risk historically was largely the same independent of the size of the fund.

FIGURE 6: Historical Average IRR of Small Buyout Funds vs. Large Buyout Funds



Source: Kempen analysis of Preqin data per December 2018. Small buyout funds represent all funds with AUM less than $500m and large buyout funds include all other funds, i.e. all funds with AUM larger than $500m. The value of your investments may fluctuate. Past performance figures provides no guarantee for the future.

Conclusion

Small companies represent a key part of the overall European economy and are in our opinion a fertile breeding ground for tomorrow's leaders. Our research shows that it is at the small end of the market, rather than among the biggest companies, that private equity deals with the highest return potential are to be found. Attractive valuations, low leverage and multiple ways to create value lead to compelling investment opportunities within the small buyout segment.
Given the breadth of the opportunity, and to avoid the common pitfalls, we believe it is important to partner with local private equity investment specialists who are best placed to source, analyse and invest in the most attractive deals. These specialists typically manage small buyout funds that are 'under-the-radar'. It requires skill, experience and a dedicated network to find and get access to these specialists.

We trust that this paper will contribute to a better understanding of private equity in general and more specifically the small buyout segment. Please do not hesitate to contact us if you have any further questions on the content of this paper or require more information.

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