GUEST ARTICLE

# Private Equity's Little Secret: Opportunity In The Small Market

**By Kevin Kester**

Warren Buffet once said "I'd be a bum in the street with a tin cup if the markets were efficient."

Mainstream private equity investors have wondered at times if they shouldn't start panhandling (think of your favorite mid-to-late 1990's vintage large buyout fund), and will probably consider this vocation again if history repeats itself.

There is, however, a place within private equity where inefficiencies abound and imperfect information and processes combine to reduce competition and reward skilled managers. This place is filled with hundreds of thousands of target companies, many of which provide highly value-added products and services and are well run by smart, dedicated and hardworking managers. No, I am not talking about Silicon Valley, but instead an incredibly dynamic and inefficient market of small (sales under $100 million) companies with positive cash flow and established operating histories.

The core of a well-executed small buyout investment is the entry multiple.

Healthy supply-demand characteristics, inefficient processes, and lower levels of leverage help produce lower purchase price multiples relative to larger transactions. Although purchase price multiples across the spectrum of buyouts have increased since the trough in 2002, the savvy private equity investor is still able to exploit inefficiencies common to smaller transactions and acquire quality businesses for multiples of around 5x EBITDA. In the current environment, this means persistence and a knack for uncovering unique opportunities.

It also often means partnering with the owner to build the business rather than completely buying them out, because an owner "rolling" a significant portion of equity is more likely to value intangibles such as perceived value-add and "chemistry" rather than purely price. These owners want a partner to help them grow—one they can get along with and feel good about bringing into their "home"—not just the highest bidder. This dynamic is one of the key elements of smaller deals (specifically family-owned businesses) and is why, even in an environment of increasing multiples, the better private equity managers are able to maintain value discipline.

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Buying free cash flow at 5x or 6x effectively generates a 16%-20% un-levered internal rate of return. Assuming modest 1:1 debt to equity, the leveraged IRR will range from the mid 20's to the low 30's, depending on financing terms, thus reinforcing the importance of buying right. Moreover, these numbers assume no growth and no multiple expansion, even though the former is almost always part of the investment thesis and the latter is considered gravy for a job well done. Buying in at an attractive entry multiple is an important part of the performance equation and one that provides good downside protection, but it is only the beginning of a dynamic value creation process that is the hallmark of the small market.

### Less "L," More Value Creation

Small buyouts are harder to execute than traditional LBOs, namely because "L" is less available than for larger deals. Accordingly, investors in this space tend to rely much more on intrinsic value creation and growth rather than financial engineering to produce superior performance. Smaller public companies consistently tend to have higher growth rates than their larger counterparts, and the same holds true in the private markets. However, many small businesses must build out infrastructure and create a solid foundation before embarking on a serious growth plan. Private equity managers often undertake a multi-step process to build this foundation, including fundamental changes such as creating an independent board, developing a performance-based compensation plan and soliciting senior management to invest personally in the company.

Other modifications include management team upgrades, typically focused on upgrading the finance function (which is code for replacing the CFO), bolstering sales and marketing (often with the hire of a VP or director of sales and marketing), and filling in management gaps. Once the right people are in place, the focus may turn to improving financial accounting and management information systems so that management can effectively measure their business and understand the drivers of value. Additional value creation opportunities might include selling company-owned real estate, renegotiating leases, leasing rather than buying equipment, establishing a revolver, improving trade finance, supplier audits and closing down pet projects. The important point here is that there are many ways to add value to small companies, many of which are "low hanging fruit" for the experienced private equity manager.

Once the "easy pickings" are plucked, the focus on value creation will generally follow two paths—margin improvement and revenue

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enhancement. Companies with strong defensible market positions in low growth sectors may focus on increasing productivity, reducing inventory and decreasing working capital by implementing lean manufacturing techniques, while businesses with strong brands in faster growing niche markets may sacrifice some margin to emphasize organic or strategic growth to build market share. As growth and margin improvement are not mutually exclusive, small companies that are able to gain economies of scale through growth may see their profit margins increase along with their sales.

In any event, the ability to grow top and bottom line is key to achieving the holy grail of multiple expansion, which typically occurs (assuming the manager bought right to begin with) as companies hit EBITDA thresholds. In the current environment, we see valuation inflection points at approximately $7-8 million of EBITDA and again at $15 million. Companies that reach these plateaus become more attractive to sophisticated intermediaries, who in turn stir up demand by soliciting both strategic and financial buyers via a competitive auction process. Although multiple arbitrage can never be taken for granted, it is the icing on the cake for the small company private equity investor that can take a solid 3x-4x return into the stratosphere of 6x-10x and higher.

### Special Breed

In the small buyout world, private equity managers are more likely to be seen walking the floor of the National Association of Truck Stop Operators convention than pontificating at a private equity conference, because "there ain't no small and lower middle-market deals at the Waldorf."

Eschewing the traditional investment bank deal flow feed trough is not for everyone, but it is a necessity for successful small and lower middle-market managers. Managers in this space regularly don their blue jeans and work boots to walk the factory floor and often spend many months or even years developing a rapport with the owner and management. The amount and depth of due diligence afforded a private equity manager who has created a connection with the entrepreneur over several meetings, including perhaps cocktails at their country club or a home cooked meal with their family, is well beyond the level of insight available during a well-run investment banking process. An auction is designed to force prospective investors into making quick decisions based on limited information and controlled contact with the seller or management. In contrast, a direct negotiation with the owner creates greater transparency into the business and often provides the opportunity to see how a company performs over many quarters. Time and relationships are key allies of the small market private equity manager.

Small and lower middle-market private equity managers not only invest differently; they also march to their own beat when running their own business. Although some private equity firms start small, then move "up-market" with success, many successful small-buyout market managers stay small because they are good at it and see more opportunity in this sector. Managers who have been successful and stayed small cite the top-tier venture capitalists as examples of how important fund size is to maintaining discipline and performance. Having pride in one's investment performance is a prevalent trait in these managers, as is the belief that entrepreneurially oriented investment management is not necessarily scalable. Private equity managers focused on the small and lower middle-market believe that dilution occurs as firms get bigger—dilution of investment talent and dilution of good ideas. Rather than looking to build larger organizations that take senior partners away from day-to-day investing and into firm management and administrative responsibilities, the general partners of a small market fund are able to concentrate on their highest and best use—doing deals.

What does this mean for limited partners of small and lower middle-market funds? Generally, it means much stronger alignment of interests as the GP's wealth creation is overwhelmingly tied to the performance of the fund. A recent industry publication estimated that a $1 billion private equity fund might generate as much as $3.3 million of management fees per partner per year while an $8 billion fund produces $5 million. Contrast this to the typical $150 million small buyout fund that averages $800,000 per partner per year. The numbers become even more distorted when transaction fees are factored into the analysis.

Along with the enhanced alignment of interests comes another benefit for limited partners. Since small private equity managers create wealth only through investment performance, as they are not getting rich on their fees, these managers must be willing to take risk, and risk-taking is a prerequisite for generating alpha. Obviously, risk-taking in and of itself is not a guarantee of better performance, but it is a precondition and one that often is lost as firms grow their asset base and brand to the point of looking like overfed asset accumulators who confuse investing with protecting their fundraising franchise.

So, it is true that good things come in small packages, but please keep this little secret to yourself. It won't be hard to do since the industry and press tend to focus on all things mega—funds, fees, deals, consortia, egos and inevitably mega-blowups. In the absence of the glare of the spotlight, we will have to be content in the target rich, underserved and perpetually inefficient small buyout market. ❖

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