Micro Private Equity:
Generating Returns in an Expensive and Overcrowded PE Market

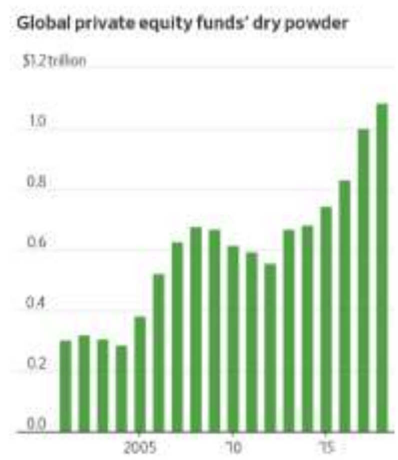
Private equity has enjoyed an unprecedented run of success over the last decade. Investors have been rewarded with outsized returns and successful funds are finding themselves oversubscribed. However, the landscape has shifted.

The number of private equity funds and other entities seeking to invest directly has risen sharply. With entry multiples at record levels and funds lowering IRR targets, how can investors continue generating strong returns from their private equity allocations?

A significant segment of the economy—companies with EBITDA up to $5 million—still offers reasonable prices and room for growth but has been largely ignored by private equity. Osceola Capital Management is one of the funds now covering this segment of the lower middle-market, a strategy they call Micro Private Equity.

Imbalance in Private Equity: Causes and Effect

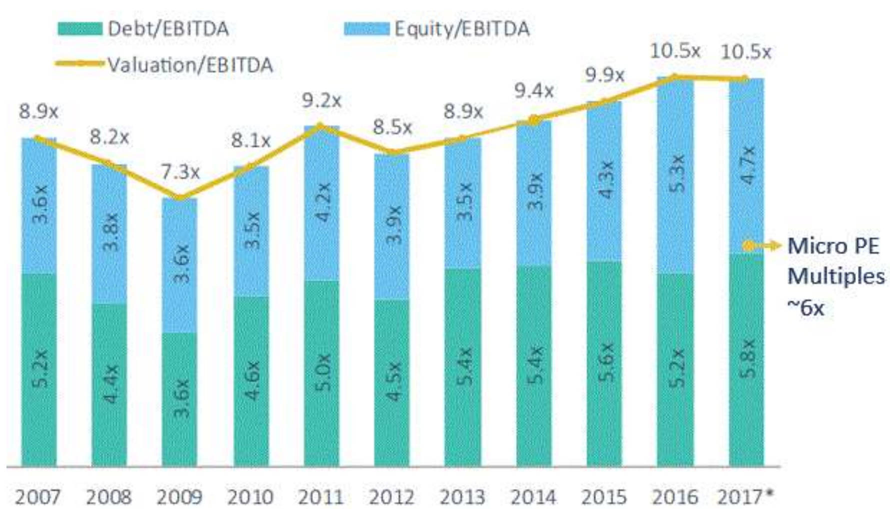
Global private equity buyout deal values rose nearly 20% in 2017 from the previous year while the number of deals closed was essentially unchanged. This gap demonstrates the primary challenge now facing private equity: firms sit on a record $1.1 trillion of dry powder but lack attractive opportunities to deploy it amid additional buyout competition from corporations and family offices which has collectively pushed average purchase multiples to historic highs.



Note: At year end, except 2018 which is as of June 30.
Source: Preqin

Record Multiples, Even in the Middle and Lower Middle Market

Swelling multiples are not isolated to the upper reaches of the market. When larger investors could find appealing investment opportunities and adequate deal flow upstream, they typically eschewed small and mid-sized companies in favor of the scale afforded by larger deals.



Source: PitchBook. *As of 9/30/2017
Micro PE Multiples source Osceola

However, the run up of entry multiples has resulted in bulge bracket private equity firms reaching downstream into the middle and lower middle markets to find investment add-on opportunities at justifiable prices.

The result has been buyers now paying approximately the same amount per dollar of EBITDA for small and mid-sized companies as they are for large ones.

PE Returns Driven by Exit Multiples, Operational Execution Negligible

A study by Bain & Company found that private equity's robust success in recent years has been attributable almost entirely to frothy exit multiples. In the study of proprietary deal data, Bain compared pre-deal forecasts with actual results. Most acquired companies missed projected profit margin growth but exit multiples outpaced forecasts. The surge of exit multiples concealed shortcomings in operational execution and drove new commitments back into private equity. In short, the factors most responsible for private equity's boom are now positioned as headwinds.

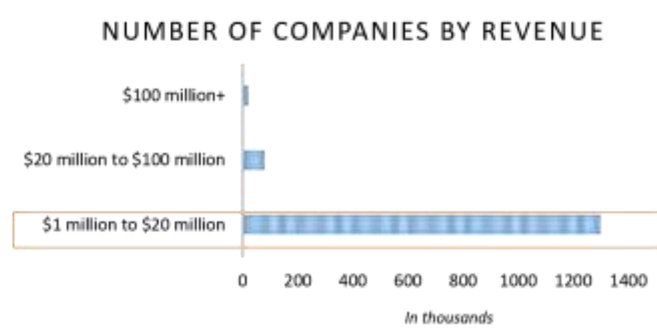
If entry multiples have been the best predictors of private equity returns while private equity operational contributions have been negligible, investors are left with few enticing options in the current environment. As more GPs take to the sidelines waiting for prices to drop, LPs are faced with the potential of either paying sky-high prices or locking up their money for years without it ever being invested.

Where can Investors go?

Osceola Capital Management coined the term Micro Private Equity to define the private equity strategy of investing in the lowest end of the lower middle market (companies with up to $5 million in EBITDA). This contrasts with lower middle market private equity funds which typically seek out companies with $10 million or more in EBITDA and will then reach down lower for add-ons.

The Micro Private Equity Opportunity

- The Price is Right: According to Pitchbook, by the end of 2017, median entry multiples in buyout deals up to $25 million hovered around 6x EV/EBITDA, roughly half the amount of larger deals. The more telling trend is the relative consistency of the sub-$25 million deal multiples which have fluctuated within a small range over the last four years, the period in which deal multiples upstream have swelled over 20%.
- Significant universe of potential acquisition target companies: According to US Census and IRS data tallied by Compile, there are approximately 1.3 million US companies with annual revenue from $1 million to $20 million. For comparison, there are only about 100,000 companies with revenue greater than $20 million. This robust supply of candidate companies solves the supply/demand imbalance and spares Micro Private Equity firms like Osceola from having to pick through the late inning leftovers of the current economic cycle.



- Abundant low hanging fruit: Buying companies in the Micro Private Equity segment often means partnering with operators who know their businesses intimately but lack operational sophistication. This affords Osceola the opportunity to realize early significant gains from implementing processes and systems to increase efficiencies.
- Arbitrage through rollups: Osceola seeks out add-on acquisitions within highly fragmented industries to leverage natural arbitrage opportunities. The large universe permits Osceola to select the most attractive opportunities when sourcing add-ons.

Due to these unique tailwinds—a significantly larger and untapped pool of candidate companies, entry multiple stability and abundant opportunity for organic growth through operational improvements—Micro Private Equity funds still generally target IRRs of 25% while many larger funds have ratcheted down IRR targets to the mid-teens.

Barriers to Entry: Insulating the Micro Private Equity market from Bulge Bracket

The buyout market's evolution over recent years would suggest the stability of multiples in the Micro Private Equity segment simply positions it to be the next bought up by bulge bracket firms bringing multiples in-line with the rest of the market. A closer look reveals significant barriers to entry that will continue to insulate Micro Private Equity.

- Impractical Deal Size: Large Private Equity funds charged with deploying billions of dollars will not achieve necessary scale in the Micro Private Equity space. Filling out a portfolio with acquisitions of this size and then managing that number of companies is unfeasible.
- Heavy Operational Involvement: Acquiring companies in the Micro Private Equity space requires stepping into organizations that often lack necessary infrastructure and processes. Sophistication enhancements are needed, cultures must be combined when add-ons are acquired, information and reporting must be merged and made efficient and capital structures require creativity since traditional bank leverage is not readily available.
- Mining a Larger and Undercovered Playing Field: While there is an oversupply of attractive target companies, finding these opportunities requires rigorous monitoring of target industries through non-traditional channels as opposed to collecting CIMs from investment banks—the typical private equity sourcing process.

Complimentary to Existing Private Equity Allocations

Private equity funds originally offered access to deals too large for the typical investor to participate in individually. Micro Private Equity investing flips that value proposition by offering investors access to a collection of deals too small for the typical investor to source and manage. For this reason, Micro Private Equity rollup investments slot in nicely alongside existing private equity allocations due to their differentiation and lack of cyclicality in entry multiples. As a result, returns are more consistent and tend to outperform the broader private equity market in heated or peak cycle investment vintages.

Investing Directly versus Funds

Attempting to gain exposure to the Micro Private Equity space through direct investing is a difficult task. Developing a proprietary pipeline to source deals is a long process and operational expertise is necessary since post-close involvement is so hands-on. A lack of diversification is also problematic with this approach. By investing through a fund, the investor can leverage the fund's network for deal sourcing, outsource the operational headaches of reshaping a small company and access diversification across various verticals.

How to Invest and Who are the Players?

Surveying the challenges of the private equity landscape makes a compelling case for Micro Private Equity investing. Micro Private Equity funds like Osceola escape many of the headwinds now facing larger private equity funds. LPs need opportunities where their committed capital will be deployed at reasonable multiples and can still garner the returns they have come to expect from private equity allocations. However, finding funds that both operate in the Micro Private Equity segment and possess the necessary operational expertise along with proven success in sourcing and executing deals is challenging. Numerous funds have assumed the banner of lower middle-market investing in recent years. Far fewer have branched into the Micro Private Equity space.

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Osceola Capital Management offers access to the Micro Private Equity segment of the economy with proven results. The firm's investment team possesses deep operational experience having founded, run and sold successful businesses.