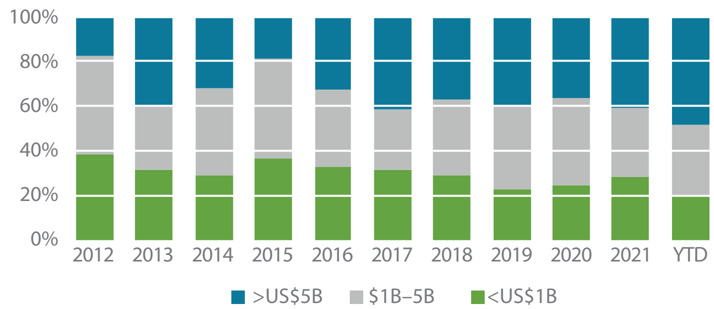
STEPSTONE
inside private markets

Fight the Urge
(To Cut Back on Small Buyouts)

As inflation rages, and central banks raise policy rates, concerns about the health of the economy have been front of mind. Although the US has so far managed to avoid a recession, many consumers and investors are hunkering down.

When the economy shrinks, consumers respond by paying down debt, saving more, and spending less on nonessential goods. Institutional investors, on the other hand, adjust the "tilts" of their portfolios. They increase their allocations to defensive assets like infrastructure, private debt and real estate, and seek reassurance with larger, more familiar private equity fund managers. Necessarily, this comes at the expense of small, emerging and, by extension, diverse managers, which some regard as riskier than their larger, "more proven" counterparts **(Figure 1)**.

FIGURE 1 | SHARE OF GLOBAL PRIVATE EQUITY CAPITAL RAISED BY FUND SIZE



Source: PitchBook, September 30, 2022.
Note: Excludes venture.

January 2023

The institutions that reduce their allocations to private equity's small market during turbulent markets treat this tranche of the buyout market as a luxury good, something that is consumed when the economy is booming. Instead, we think investors should consider it a staple that can bolster and diversify their portfolios regardless of the macroeconomic backdrop. If anything, LPs should lean in.

As global investors contemplate their 2023 budgets and allocation targets, they should resist the temptation to pull back on small-market buyouts. Contrary to what LP actions would imply, we believe the current market conditions and private equity landscape make the small market particularly attractive.

Why Now May Be the Time to Lean In

The segment of the market we refer to as small-market buyouts (SBO) consists of private equity GPs that raise funds smaller than US$1 billion while investing in companies with a total enterprise value (TEV) of US$250 million or less. Although there are several benefits to investing in SBO, we have chosen to highlight the ones that are most salient to current market conditions.

VAST OPPORTUNITY SET YET UNDERALLOCATED

The small market is the largest and most dispersed tranche of the buyout market. In the US, which has the largest and most mature SBO market, it is much larger than the middle and large markets combined **(Figure 2)**.

The small market is home to nearly 90% of private companies in the US yet represents only a fifth of the capital raised. LPs' propensity to cut back on SBO during downturns means there will be even less capital chasing the segment.

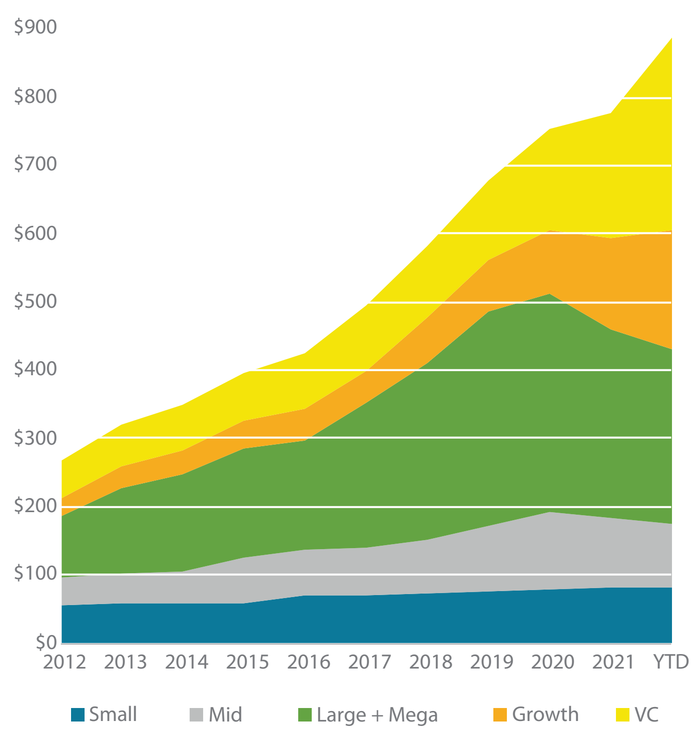
As seen in **Figure 3**, SBO dry powder has increased modestly compared with other strategies, growing at a CAGR of 3% between 2016 and 2021. There is a direct link between capital availability, competition and valuations. While the trend lines for each have been up and to the right across the entire buyout market for many years, SBO has been most insulated from this frothiness and is most attractively positioned from a capital-to-opportunity-set perspective.

FIGURE 2 | US PRIVATE BUYOUT MARKET (2017–2021)

Tranche	Capital Raised (US$ Billions)	No. of Companies	Total Revenue (US$ Trillions)
Large	704	895	5.3
Middle	270	17,328	6.4
Small	273	114,795	2.2

Source: Capital IQ, December 31, 2021. Here, small is defined as companies whose revenue is \$10M–100M; middle as \$100M–2B; and large as >\$2B.

FIGURE 3 | PE DRY POWDER BY TRANCHE



Source: Preqin, November 2022.

GREATER FOCUS

Most SBO funds target businesses with less than US$25 million of EBITDA, with the highest volume of deals occurring in the sub–US$10 million segment (**Figure 4**). Businesses of this size are less likely to be represented by sophisticated intermediaries (if they are represented at all), enabling SBO managers to source investments in a less competitive environment. Many firms develop custom outreach strategies that require dedicated professionals and extra resources. By sourcing more directly, SBO firms generate value from price inefficiencies, improved asset selection and greater awareness of the true operational value-add potential of a business. These inefficiencies drive outperformance and lower correlation in private equity. They are even more pronounced during—and immediately following—volatile markets.

OPERATIONAL IMPROVEMENTS

Operational value-add, or the ability to create value by making operational improvements, has become an important way for fund managers to make portfolio companies more valuable. Because SBO managers invest in smaller, less established companies that have fewer resources and less efficient processes, there is more room to create value by installing skilled management teams, upgrading technology, and investing behind or professionalizing the sales function.

When markets are turbulent, industries consolidate and market leaders stumble. Opportunities to transform a business, take share and improve competitiveness are plentiful.

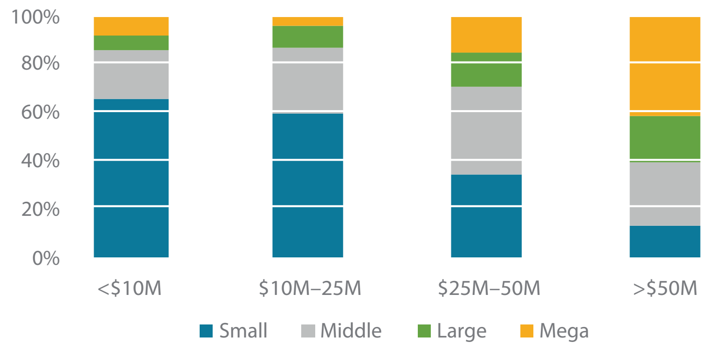
LESS LEVERAGE

A contributing factor to SBO's capacity for making operational improvements is its lower use of leverage. As seen in **Figure 5**, which illustrates leverage multiples for various tranches of the buyout market, small-market companies have used considerably less leverage than their larger counterparts. Because they have less debt to pay down, small-market companies have more free cash flow to reinvest in their businesses. This is especially apt as central banks the world over raise rates to combat inflation.

MULTIPLE EXPANSION

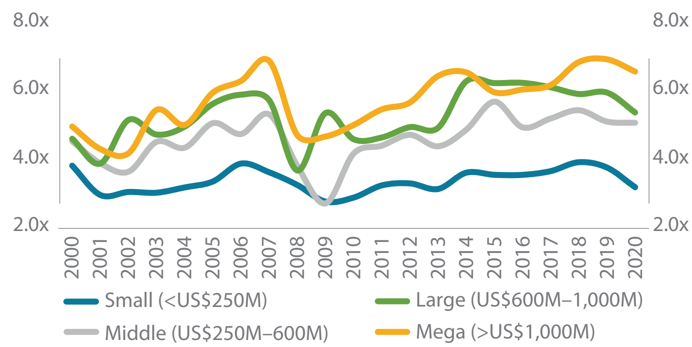
Historically, purchase price multiples have been much lower for small-market companies (**Figure 6**). And while the low-interest-rate environment that has characterized the past 20-plus years has allowed valuations to increase for all assets, entry multiples for small-market companies have risen more modestly.

FIGURE 4 | EBITDA AT ENTRY BY TRANCHE



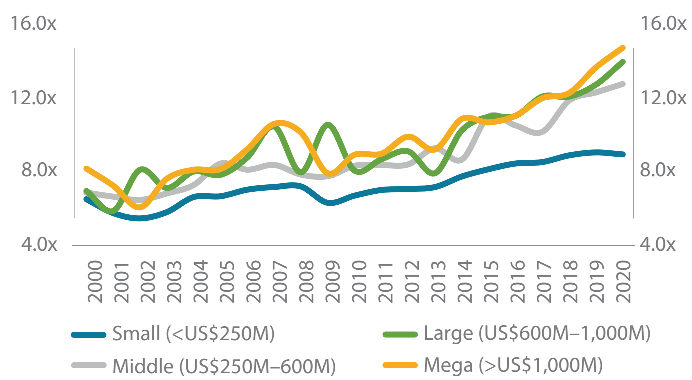
Source: SPI, October 2022.

FIGURE 5 | DEBT MULTIPLES FOR NORTH AMERICAN BUYOUTS (MEDIAN NET DEBT/EBITDA)



Source: SPI and StepStone Portfolio Analytics & Reporting (SPAR), March 31, 2022.

FIGURE 6 | ENTRY MULTIPLES FOR NORTH AMERICAN BUYOUTS (MEDIAN TEV/EBITDA)



Source: SPI and SPAR, March 31, 2022.

Low entry multiples and a greater capacity for operational improvements create ideal conditions for multiple expansion. Harkening back to Figure 3, ample dry powder, particularly upmarket, suggests the pool of potential buyers is well funded.

"HOME RUN" POTENTIAL

Large sponsor interest in high-quality assets that can serve as a platform for consolidation of high-growth or fragmented sectors can lead to home run deals. Of the 387 realized North American buyout deals we track that have generated a 10x outcome or better, 77% were in SBO funds **(Figure 7)**.

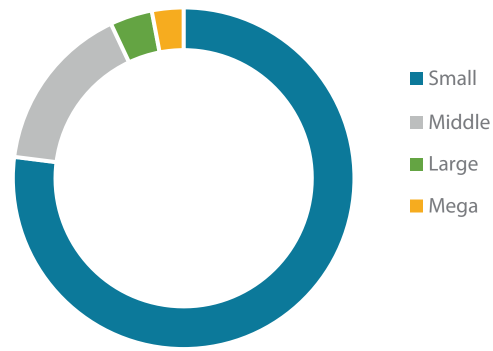
While multiple expansion can certainly boost an outcome from good to great, it's not required to generate strong returns given the other value creation levers available in the small market.

In response to questions around the sustainability of multiple expansion as a source of return, one should ponder the impact on both existing and new deals. While the range of potential multiple expansion may compress on existing deals, valuations for new deals have also compressed, providing the same opportunity for multiple expansion in the future. Simply put, multiple expansion is a feature of the valuation environment and competition (read: dry powder) at different segments of the buyout market, which we believe positions SBO well for the foreseeable future.

SENSITIVITY TO PUBLIC MARKET VOLATILITY

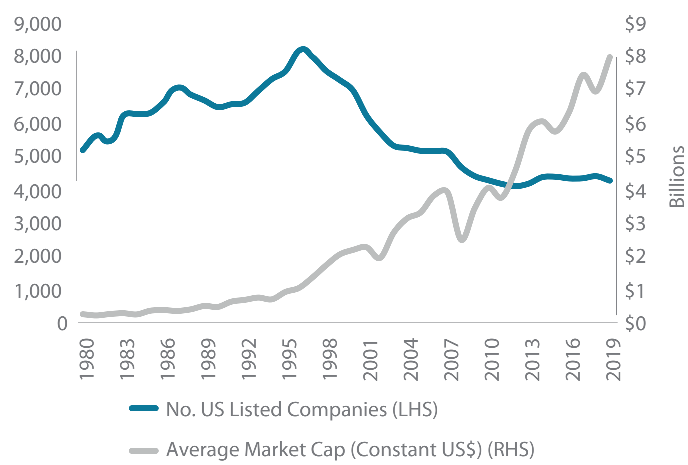
Adding private markets to a traditional portfolio provides exposure to assets that may be underrepresented in listed markets. Over the past 30 years, the size and composition of listed markets have changed markedly. As seen in **Figure 8**, the number of public companies has fallen by half. At the same time, the average market cap has grown markedly, suggesting the number of public micro- and small-cap companies has fallen as well. Investors building well-rounded portfolios are therefore looking increasingly to the private markets to gain small-cap exposure. Moreover, because small-market companies are underrepresented in stock markets, they are less sensitive to swings in the stock market than larger companies.

FIGURE 7 | REALIZED >10X TVM BUYOUT DEALS



Source: SPI, November 2022. Includes 387 North American buyout deals.

FIGURE 8 | NUMBER OF US LISTED COMPANIES & AVERAGE MARKET CAP



Source: World Bank, July 2022.

To get a sense of just how sensitive, we compared the peak-to-trough performance of mega, large, middle and SBO funds with the public markets' during three crash and recovery cycles: the dot-com bubble, the Global Financial Crisis (GFC) and Covid-19. We refer to this analysis as upside/downside capture.[1]

[1] Downside is defined as the maximum drawdown between the peak and trough during a crisis; upside is the annualized return between the trough of the previous crisis and the peak of the next crisis. Dot-com peak March 31, 2000, trough September 30, 2002; GFC peak September 30, 2007, trough March 31, 2009; Covid peak December 31, 2019, trough March 31, 2020; post-Covid peak September 30, 2021.

Figure 9 illustrates the market capture during the GFC. As you can see, SBO valuations rose 13.7%, capturing 91% of the gains in the public markets, on average. By contrast, mid, large and mega fund valuations rose by 15.2%, in line with the public benchmarks. However, upside is only half of the picture. To get a sense of how the two tranches performed during the entire cycle, we also examined the downside. From their peak at the end of September 2007, SBO valuations fell by 12.6%, roughly 75% less than either public benchmark. Mid, large and mega fund valuations, by contrast, fell by more than one-third, capturing closer to 70% of public market downside. These results were fairly consistent across all three cycles. On average, we found that SBO captured 30% of market downside and 94% of upside.[2] This seems to run contrary to the popular assumption that SBO is riskier than other buyout strategies. How can this be?

Several factors may explain why small-market funds are less sensitive to fluctuations in equity markets.

1. Because the preponderance of small-market companies are privately held, there are fewer comps in the public markets. Conversely, if there's a direct public comp to a mega or large company, it is hard to argue against taking a similar mark (i.e., what the company would sell for today).

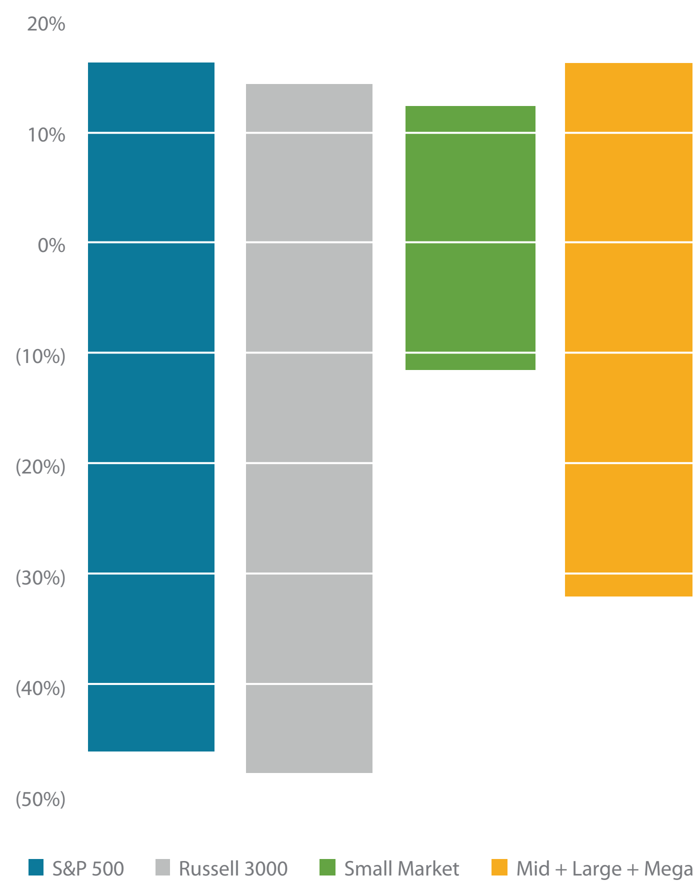
2. SBO funds are generally more conservative in marking up businesses despite mark-to-market accounting (remember the old adage "Under-promise, over-deliver"?). You could say they're "old school" but the reality is mega and large buyout funds are more visible (some GPs even public themselves) and possibly held to more stringent accounting standards.

3. Large buyout managers tend to come back to market sooner, often raising capital for alternative strategies or products or both. Therefore, interim returns matter. This speaks more to upside capture.

4. SBO funds depend more on carry than management fees, which are calculated from a smaller basis. Small-market managers generally care more about exits than interim marks.

[2] To see how funds performed during other cycles, refer to Appendix A.

FIGURE 9 | GFC PEAK-TO-TROUGH PERFORMANCE



Source: Capital IQ, Burgiss Private iQ, SPAR Analytics, June 2022.

Challenges & Solutions

For all its benefits, SBO can present LPs with some challenges. It has more managers than any other segment of the buyout market. That many of these GPs are new or emerging means there are a lot of unproven teams and track records to decipher. Moreover, the difference between first- and fourth-quartile managers is widest for SBO.

The importance of manager selection is a common refrain in private markets. Within buyouts, this axiom rings truest for SBO

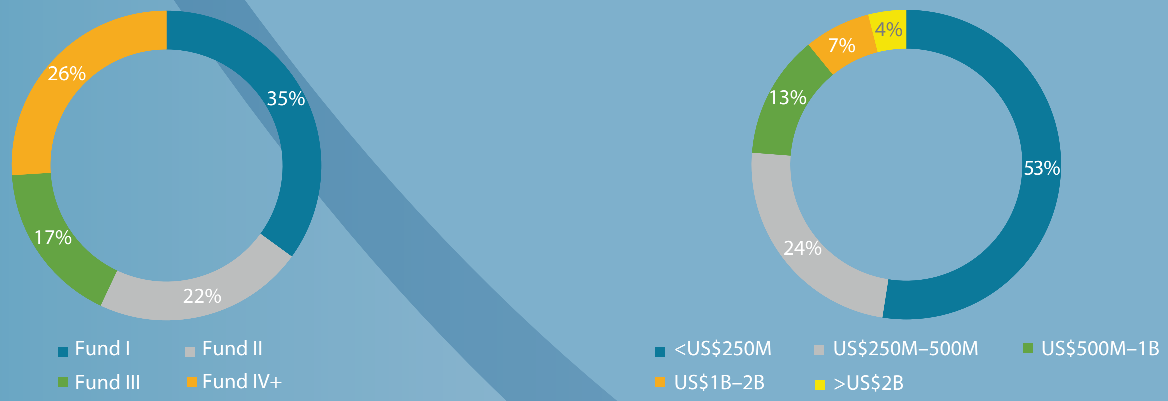
SBO Can Offer Great Access to Diverse Buyout Managers

We define a diverse fund as one that passes our so-called 33% test.[3] Of the 1,400-plus North American buyout managers we track in SPI,[4] 128 have raised a fund that passes this test. SBO managers account for 100 of them. As seen in **Figure 10**, diverse managers not only skew smaller but younger as well. Nearly three-quarters of diverse-managed private equity funds are new or emerging, and 90% are smaller than US$1 billion.[5]

A substantial body of work examining the effect diversity has on decision-making, organizational health and investment performance has emerged. While it is beyond our scope to enumerate the entire corpus of work, here are some well-known examples:

- A 2018 *Harvard Business Review* study found that homogeneous investment teams had less successful acquisitions and IPOs.[6]
- In a 2019 study, Bella Private Markets, a consulting group led by Josh Lerner, found that private equity funds owned by women and minorities accounted for 29% and 34% of top-quartile funds, respectively.[7]
- A 2021 study by the National Association of Investment Companies found that diverse private equity funds beat the Burgiss median across several key performance indicators: net IRR, MOIC and DPI.[8]

FIGURE 10 | DISTRIBUTION OF DIVERSE PRIVATE EQUITY FUNDS BY AGE AND FUND SIZE



Source: SPI, September 2022.

[3] In our view, to be diverse, funds must pass at least one of the following tests: One-third of ownership counts as diverse; one-third of carry goes to diverse individuals; or one-third of individuals covered by a fund's key-person clause are diverse.

[4] As of September 30, 2022. StepStone Private Markets Intelligence, our proprietary research library, garnered data on more than 15,000 GPs, 40,000 funds and 180,000 investments.

[5] We define new managers as those raising a Fund I; emerging managers as those raising Funds II–III.

[6] Gompers, Paul and Kovvali, Silpa. 2018. "The Other Diversity Dividend." *Harvard Business Review*, July.

[7] Bella Private Markets. 2019. "Diverse Asset Management Firm Assessment."

[8] National Association of Investment Companies. 2021. "Examining the Returns 2021: The Financial Returns of Diverse Private Equity Firms."

SBO Can Offer Great Access to Diverse Buyout Managers (cont.)

We have observed similar outcomes in our diverse manager track record (**Figure 11**).

» For primary buyout and growth equity funds, diverse managers' net TVM of 1.6x outperforms the benchmark median of 1.49x over the same vintages.[9]

» This outperformance has been concentrated in the lower end of the market, where funds raising less than US$2 billion have generated a net TVM of 1.8x.

FIGURE 11 | STEPSTONE DIVERSE MANAGER TRACK RECORD

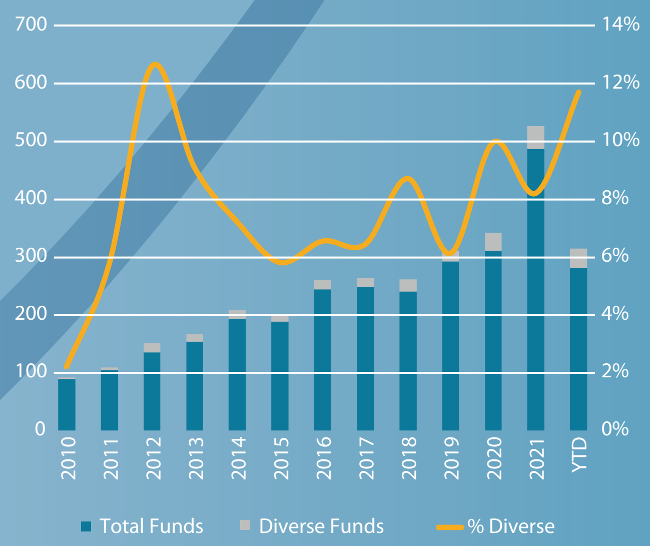
Strategy	# of Investments	Vintages	Commitments (US$ Billions)	Gross IRR	Gross TVM	Gross DPI	Net IRR	Net TVM	Net DPI
Primaries (all fund sizes)	74	2008–2022	13.9	22.0%	1.6x	0.5x	21.7%	1.6x	0.5x
Primaries (<US$2 billion)	56	2008–2022	4.1	24.2%	1.8x	0.8x	23.8%	1.8x	0.8x

Source: StepStone Group, June 30, 2022. Track record includes primary investments in diverse private equity managers. Limited to North American buyout and growth equity funds.

Notwithstanding these impressive returns, LPs have historically underweighted SBO where 90% of diverse talent exists. That said, the number and share of diverse funds has been increasing (**Figure 12**).

Though promising, it all feels a bit too frail. Unless LPs back enough of them, and diverse GPs consistently deliver competitive returns, few will survive, let alone graduate. Until that happens, SBO is buyout investors' only realistic choice. Pulling back now would be a pity: We risk losing the years of momentum it took to see an improvement in the number of diverse funds raised.

FIGURE 12 | DIVERSE FUND CAPITAL RAISING TRENDS



Source: SPI & Preqin, December 2022. SPI and Preqin data are continually updated; historical values are subject to change.

Note: Includes North America-focused buyout and growth equity funds.

[9] StepStone Portfolio Analytics & Reporting. 2022. *Omni Fund Benchmark*, June 30.

funds, which have exhibited the highest and lowest return potential relative to other tranches **(Figure 13)**.

Not only are the interquartile spreads widest for SBO, but they also have the widest average "intraquartile" spreads. When comparing SBO managers, quartile may be too coarse a measure; LPs and their advisors might consider thinking in terms of deciles.

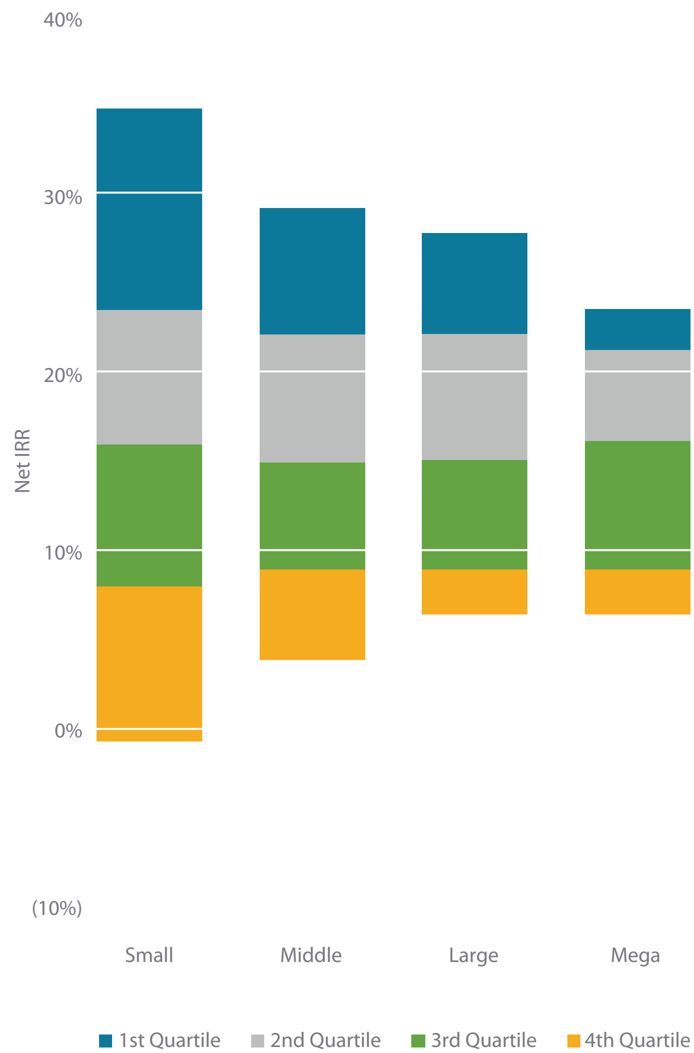
By working with a global partner that possesses a large and active sourcing engine and teams dedicated to each tranche of the buyout market, LPs can mitigate some of these challenges. For example, when evaluating a spinout, our SBO team can confer with our middle- or large-market teams to get a sense of how the new fund's investment team performed at their prior firm. Unless an LP has similar resources in-house, attempting to cover the small market can feel like a tall order, and they might feel tempted to default to brand-name managers. But is it worth it to try?

INCREMENTAL EFFORT

To help LPs determine whether they should attempt to dedicate resources toward covering small-market buyouts, we compared the hypothetical spread of performance one might expect from assembling portfolios of either brand-name or SBO funds.

We examined buyout funds raised between 1985 and 2021. To keep things simple, we defined brand-name funds as those whose fund sizes were in the top tercile (67th percentile) for a given vintage; SBO funds as those whose fund sizes were in the bottom tercile (33rd percentile). We created 100 portfolios made up of 10 funds by randomly selecting five of each fund type. To approximate hypothetical median performance—and avoid overweighting a good vintage or a poor fund—we also equally weighted vintages as well as commitments in each. We measured hypothetical performance across three dimensions:

FIGURE 13 | IRR DISPERSION FOR NORTH AMERICAN BUYOUT FUNDS



Source: Burgiss Private iQ, June 2022. Includes vintages 1998–2017. IRR for more recent vintages is not considered meaningful.

IRR, Direct Alpha and Kaplan Schoar PME. The hypothetical results are summarized in **Figure 14**.[10]

To help answer our question, we calculated the standard deviation (σ) of each measure. Harkening back to SBO's return dispersion, it should come as no surprise that SBO had a higher σ. But this wide distribution isn't necessarily bad: We found that a 1σ increase in SBO's IRR is roughly equivalent to a 1.3σ increase in brand name's.[11] In other words, the marginal return on effort is higher for SBO.

Think of this as an optimization exercise. In a world of limited time and money, we must choose how to spend either. Suppose a CIO must choose between randomly selecting one type of fund and spending resources vetting another. Clearly, they should randomly pick from the pool of brand-name managers where the marginal returns of climbing to the next decile are lower, and the risks of picking poorly are less pronounced. In assembling an SBO portfolio, a CIO needn't even aim for the top quartile; if they can get to the 40th percentile, their time and energy may have been well spent.

Conclusion

As LPs ponder the composition of their portfolios for 2023, they may feel tempted to flock to familiar managers at the upper end of the market. To this we say: Fight the urge! We believe *now* is the time to lean in to SBO. Less competition, attractive entry valuations, lower leverage, value creation opportunities, dry powder upmarket, multiple arbitrage and a low correlation with stock market volatility are several reasons why. Regardless of market cycles, SBO can play a central role in an LP's portfolio, complementing other private equity strategies by providing alternative return drivers and diversification benefits. Moreover, cutting back on SBO disproportionately affects capital going to diverse and emerging managers.

Owing to the sheer size of the small market, it is not easy to access. Unless an LP has the time, personnel and experience to vet it, they might be better served investing through a separate account or a fund of funds. However they choose to proceed, we have found investing in SBO to be well worth the effort. There's no better time than now.

FIGURE 14 | HYPOTHETICAL RESULTS OF RANDOMIZED PORTFOLIO SELECTION

	Direct Alpha		KS-PME		IRR	
Decile	**SBO**	**Brand Name**	**SBO**	**Brand Name**	**SBO**	**Brand Name**
10	5.41%	5.74%	1.22	1.24	12.82%	13.44%
20	6.06%	5.93%	1.24	1.25	13.42%	13.67%
30	6.40%	6.05%	1.25	1.26	13.75%	13.76%
40	6.66%	6.28%	1.26	1.26	14.10%	13.89%
50	6.85%	6.44%	1.27	1.27	14.36%	14.00%
60	7.24%	6.56%	1.29	1.28	14.73%	14.23%
70	7.63%	6.68%	1.31	1.28	14.99%	14.45%
80	8.04%	6.97%	1.32	1.29	15.51%	14.73%
90	8.51%	7.36%	1.35	1.30	16.11%	14.98%
100	11.55%	7.79%	1.43	1.32	19.20%	16.12%
σ	**1.28%**	**0.59%**	**0.053**	**0.023**	**1.34%**	**0.65%**

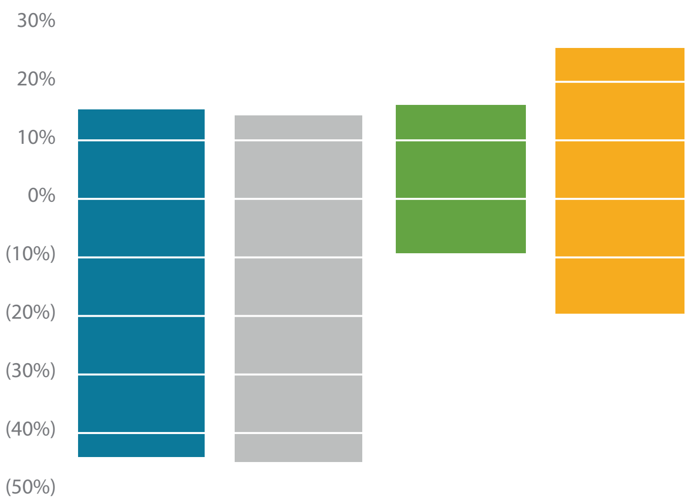
Source: SPAR Analytics, August 2022.

[10] The following model is entirely hypothetical and an illustration of returns that could be earned if the assumptions specified above occurred. Investors are advised that actual returns could vary significantly from those shown herein. Any return contained herein is hypothetical and is not a guarantee of future performance. The returns set forth herein do not constitute a forecast; rather they are indicative of the StepStone internal transaction analysis regarding outcome potentials. Any returns set forth herein are based on the belief about the returns that may be achievable on investments that the it intends to pursue. Such returns are based on the StepStone current view in relation to future events and financial performance of potential investments and various models, estimations and "base case" assumptions made by StepStone, including estimations and assumptions about events that have not occurred. Actual events and conditions may differ materially from the assumptions used to establish returns and there is no guarantee that the assumptions will be applicable to the investments. Refer to the appendix for graphical summaries of the analysis.

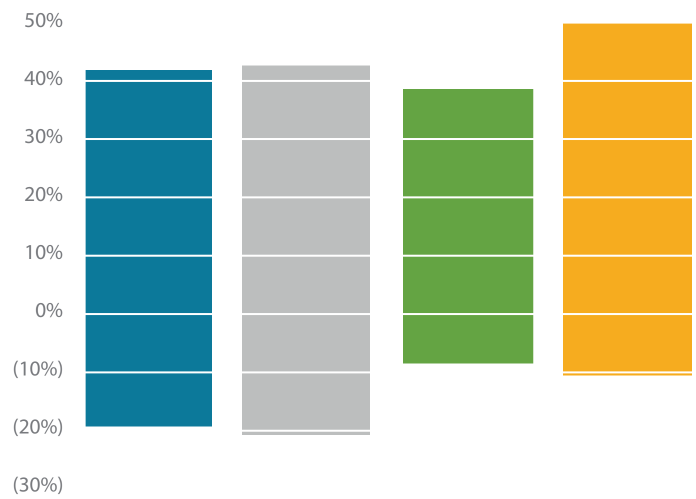
[11] This observation holds for the other measures as well. A 1σ increase in SBO was roughly equivalent to a 1.1σ increase in brand-name Direct Alpha and a 1.2σ increase in brand-name KS-PME.

Appendix A | Peak-to-Trough Performance

DOT-COM PEAK-TO-TROUGH PERFORMANCE



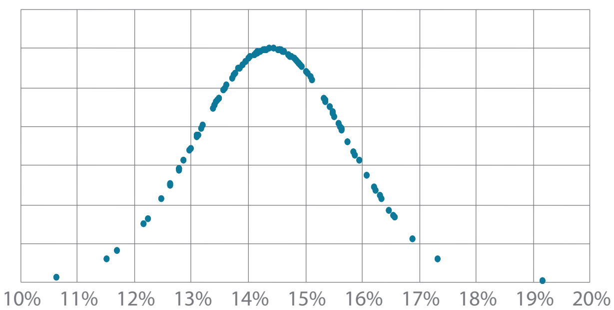
COVID-19 PEAK-TO-TROUGH PERFORMANCE



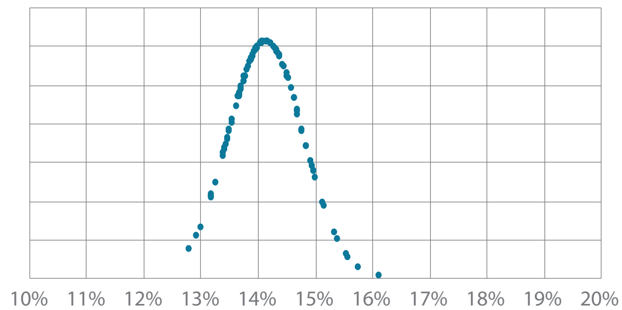
Source: Capital IQ, Burgiss Private iQ, SPAR Analytics, June 2022.

Appendix B | Hypothetical Results

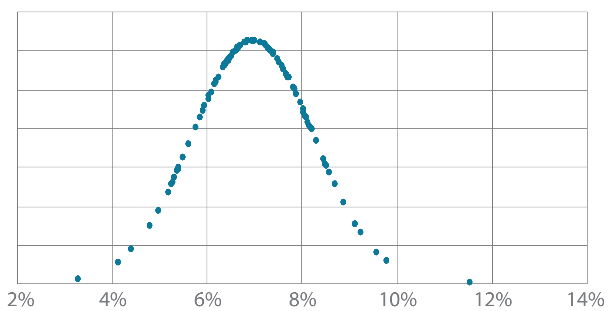
SBO IRR



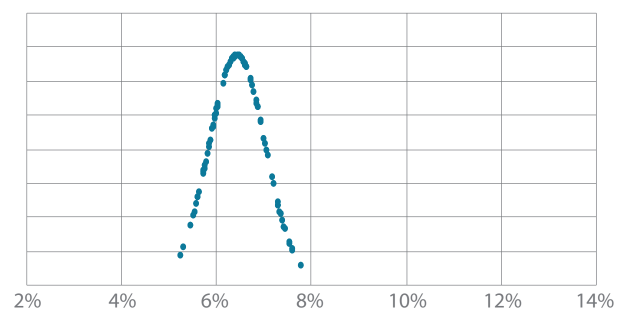
BRAND NAME IRR



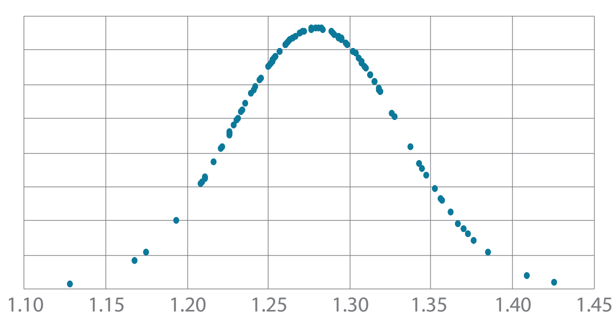
SBO DIRECT ALPHA



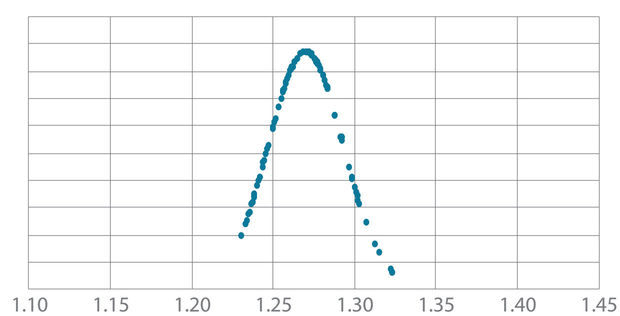
BRAND NAME DIRECT ALPHA



SBO KS-PME



BRAND NAME KS-PME



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StepStone Group (Nasdaq: STEP) is a global private markets investment firm focused on providing customized investment solutions and advisory and data services to our clients. StepStone's clients include some of the world's largest public and private defined benefit and defined contribution pension funds, sovereign wealth funds and insurance companies, as well as prominent endowments, foundations, family offices and private wealth clients, which include high-net-worth and mass affluent individuals. StepStone partners with its clients to develop and build private markets portfolios designed to meet their specific objectives across the private equity, infrastructure, private debt and real estate asset classes.

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