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Overview: The Lower Market

Lower-middle market private equity was once viewed as a trade-off between value and risk, only appropriate for the barbell of unsophisticated investors on one end and institutional investors on the other. Yet today, it's something investors can no longer afford to ignore. What has changed? More granular data, more sophisticated analysis of the characteristics can be tied to a fund's potential to succeed.

Altera has become a new leader in understanding this part of the private equity market and has carved out a prized market position that directly benefits individual investors and institutions alike.

In this overview, we discuss the themes driving transformation in lower- and lower-middle market investing. The aim for including the Lower Market is to create more diversified portfolios and strategies that do not compromise financial returns; using innovative research to go beyond headline perceptions and understanding; capitalizing on sub-institutional pricing to capture "size arbitrage", and the integration of niche and tactical allocations into traditional investment strategies to produce a win-win as we accelerate towards a more alternatives leaning global opportunity set.

Our work fuels our conviction that the future of investing is one with the lower market comprising a much larger portion of the pie.

Summary

Lower market investing is still a niche area; but it's ability to outperform is gaining awareness among various investment groups. We are seeing a surge in clients' interest in incorporating lower market illiquid investments in their alternative asset portfolios. This demand looks poised to accelerate — driven by desire for greater returns that are not as directly linked to the broad economy.

Enhanced data and insights make it possible to create lower market focused portfolios without compromising financial goals. Our research, which relies on back tested data-based reports, suggests that lower market indexes have matched or exceeded returns of their middle market counterparts, albeit with greater volatility. However, that volatility can largely be attributable to idiosyncratic risk which can be diversified away and may be further reduced based on rule-based active manager selection.

Driving innovation in lower market investing requires going beneath the headlines. Access to portfolio company data and monitoring tools have evolved but remain incomplete. New technologies and methodologies have allowed us to make great strides in improving data quality and includes techniques to estimate missing data and determine materiality.

Published February 1, 2019

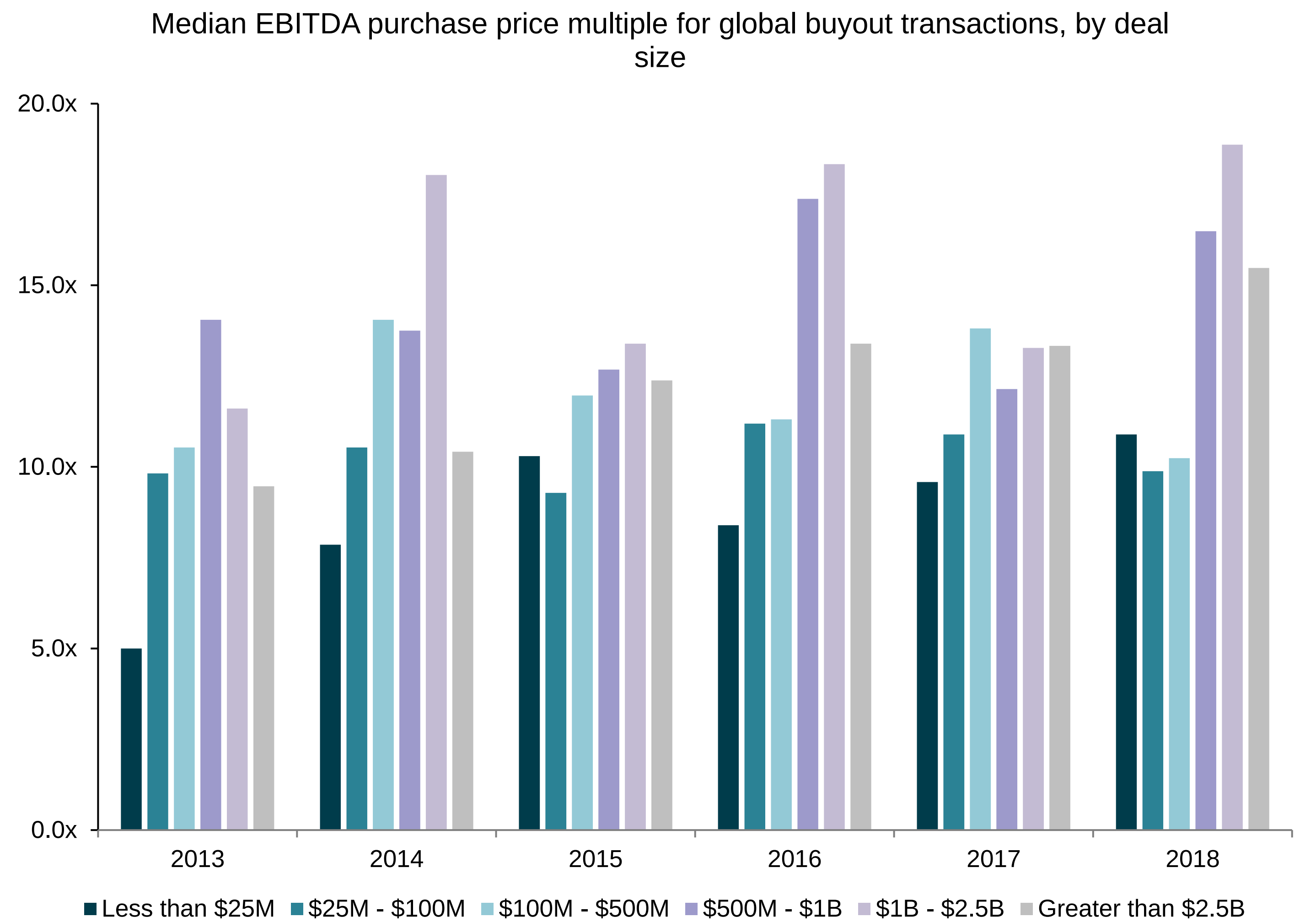
Incorporating relevant lower market insights can provide a more holistic view of the risks and opportunities associated with a given investment. There is no one-size-fits-all approach, but the opportunity to improve client outcomes by integrating lower market investments is real and growing.

More Data and Evolving Metrics

With the growing interest in alternatives investing, data providers have increased their efforts in gathering and reporting on private funds – and are starting to capture data on the lower-middle market. This is very important as one of the biggest challenges to investing in this part of the private markets is the lack of quality data. It is basically an unobservable market with ill-defined standards on limited partner agreement (LPA) terms, reporting, fees and carried interest, alignment, and peer-to-peer relative value expectations.

Multiple Expansion

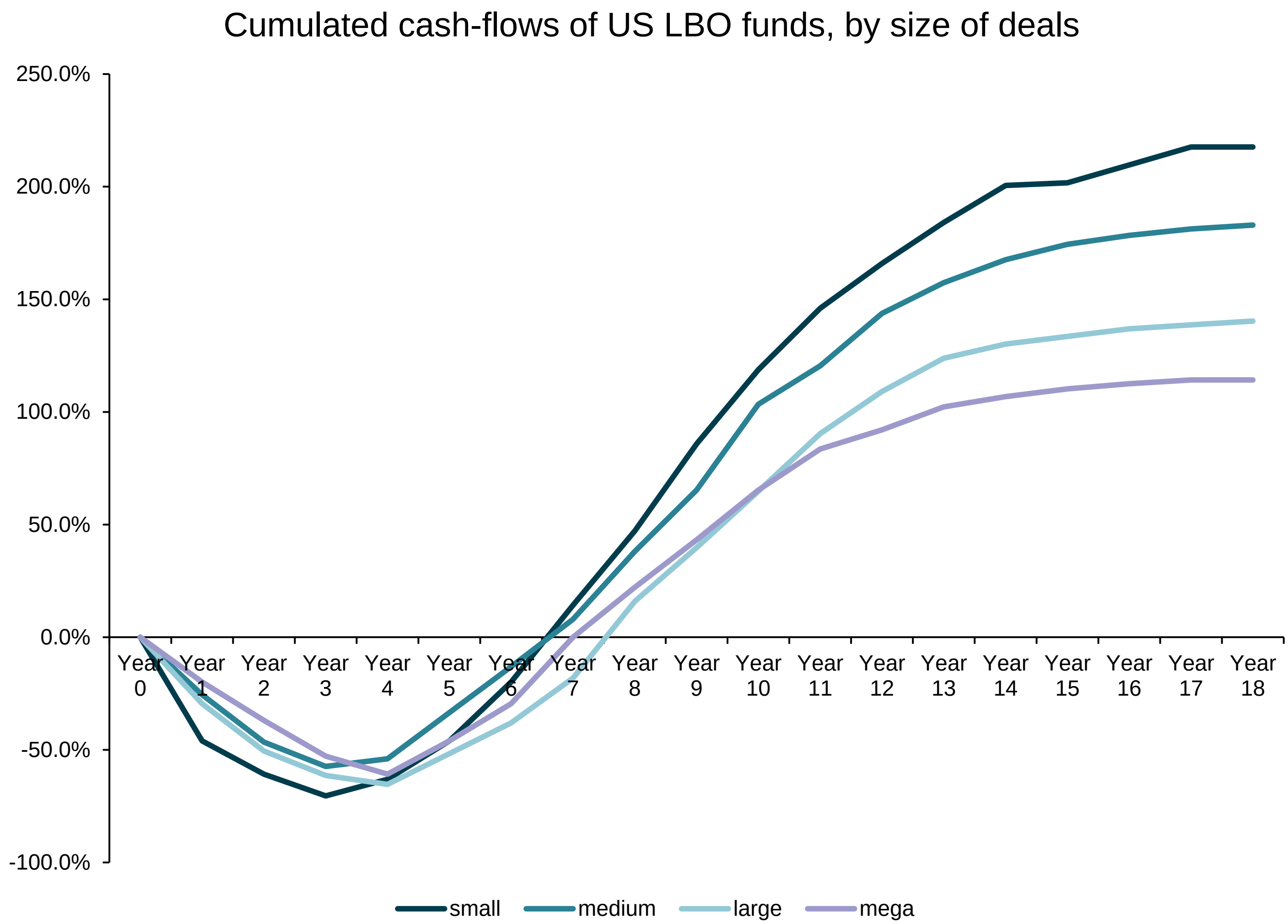
Every asset class is different but in general companies and real assets that are acquired just below “investment grade” or are viewed as sub-institutional because of their size, can benefit tremendously from this scale arbitrage with a little help.



We believe this multiple expansion will continue for at least the medium term, even as the world reaches down further into the alternative’s universe. The reason for this is that the practitioners capable of identifying and executing investments in the lower-middle market are not expanding meaningfully – and those who have been successfully often move up the value chain and start doing middle market deals. Of course, eventually the squeeze will happen, and the arbitrage opportunity will shrink, identifying new pockets of value creation. IN the meantime, this final frontier is expected to produce outsized returns for those adept.

A Win-Win for Investors

Regulatory actions and technological innovations are fueling a transition to a more alternatives focused investment portfolio. Our transition-ready investment approach focuses on directing capital to partners best positioned to win in the lower- and lower-middle market, with the aim of helping deliver competitive long-term financial returns relative to traditional benchmarks.



Beyond the potential financial uplift, a transition-ready approach can also provide better risk adjusted outcomes for total portfolios relative to standard benchmarks. As alternative assets – illiquid private equity and real assets in particular – become more in facvor, we expect pricing to have additional tailwinds in the middle and lower-middle markets, which have lagged “Big PE.”

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Published February 1, 2019