Focusing on the Lower-Middle Market

In the current market environment, with swings in interest rates from historic lows to pre-pandemic levels, and global equities roiled by the Russian invasion of Ukraine, there are few reliable sources of return. In an evolving economy, investors have been challenged to maintain the status quo, particularly as it relates to their historical capital market assumptions or expectations across asset classes. In search of yield or uncorrelated sources of return, many investors have turned to private markets to supplement their investments in public markets.

Within mainstream private market investments, investors have poured into the largest offerings. The global private equity industry held nearly $1.8 trillion in dry powder at the end of 2021, of which the top 25 largest firms held a quarter[1]. This presents an interesting opportunity for investors seeking to maximize the potential impact of their private market portfolio, particularly through the lower- to lower-middle market. Altera focuses on this space exclusively and believes that smaller opportunities present the greatest potential upside for investors equipped to navigate the space.

WHY NOT MAINSTREAM PRIVATE MARKETS?

Mainstream private markets can generally be defined as the largest, well capitalized opportunities across the industry. In recent history, we've seen demand for private market funds increase dramatically, without a comparable increase in the supply of underlying investment opportunities. This supply- and demand-driven price appreciation has an inverse effect on return expectations – in the traditional valuation sense, purchasing an asset for a higher price erodes the upside expectations an investor should have, relative to comparable assets. Further, the historical success of mainstream private markets has garnered the attention of investors with distinct investment requirements, and in many cases, these create structural impediments that impact mainstream private market funds and their respective approaches to allocating committed capital.

With respect to the challenges facing mainstream funds today, consider the following:

- **Large funds primarily raise capital from large institutions**. The primary pool of limited partners for large funds consists of institutions, namely pension funds, insurance companies, or endowments. These investors build holistic portfolios and allocate capital across all asset classes, informed by a book of liabilities, or return requirements. Due to the volume of capital they manage, they tend to make sizable investments ($10 million+) into underlying funds. From the mainstream fund manager's perspective, it's more lucrative and cost effective to focus on these large LPs, rather than raise the same amount of capital from multiple smaller sources.

- **Mainstream fund managers then must deploy a large amount of capital.** Funds that have hundreds of millions, or billions, in committed capital are expected to invest most of it (90%+). This is a point of convergence with the lower- to lower-middle market and the factor that makes accessing this space a challenge for larger funds. For example, depending on the fund's strategy, it would be less likely for a $1 billion fund to make hundreds of $5 to $25 million investments into portfolio companies with EBITDA ranging from $2 to $7 million. Each portfolio-level investment requires a substantial effort in sourcing, diligence, and execution. Working on that many deals wouldn't make sense from a cost, or human capital perspective. Conversely, it is more practical for this $1 billion fund to identify 10 to 20 investments that are larger in size.

- **Larger portfolio companies have less "low-hanging fruit."** Generally, the larger the company, the more sophisticated its financial, operational, and managerial procedures. The lower- to lower-middle market is defined as being a much less efficient market. There is a greater likelihood that smaller companies have gaps in critical areas (e.g., fragmented operations, obsolete technologies, less experienced management, lack of financial oversight, etc.), and these gaps present opportunities for fund managers to step in and generate substantial economic value on day one. These inefficiencies translate to opportunities for skilled managers and prospective outperformance for investors.

[1] S&P Global Market Intelligence; Another PE dry powder record set; VC rounds in US fintech surged in 2021, February 11, 2022.

LOWER-MIDDLE MARKET ALTERNATIVES

Fund managers that focus on the lower- to lower-middle market generally avoid many of the issues that impact mainstream fund managers. There are hundreds of thousands of small businesses in the United States with revenues in excess of $5 million[2], and generally, these tend to have flexible capital needs. This allows for greater access across smaller investors, and fund managers can execute on niche strategies, take advantage of "low hanging fruit," and generate substantial value for their stakeholders. Investments tend to be for smaller amounts into companies entrenched in local economies – supporting Main Street as opposed to Wall Street. Such private market investments are more likely to generate positive outcomes for all parties involved and are inherently less correlated with public markets.

Altera has established its own niche investing in the lower- and lower-middle market. Since our inception in 2018, we've developed an institutional due diligence platform targeting this segment of the market across all asset classes: private equity, private credit, and real assets. Through our network of independent and fund sponsors, we've cultivated strong deal flow that offers our clients the opportunity to allocate across lower- and lower-middle market investments, however it makes sense for them.

We welcome the opportunity to discuss how our approach may serve as a complement to your existing allocations.

About the Author

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[2]NAICS Association, Business Lists, Counts by Company Size, February 2022.