A compelling time for middle-market buyouts

The benefits of turning to vanilla strategies

Andrew Schardt

In most contexts, the middle seat is perhaps one of the most loathed places to be. However, if you are facing an investable landscape filled with growing uncertainty—and are (finally) convinced that trying to time the market is a bad idea—then a heightened focus on the middle-market buyout segment may be warranted. That is more than a 'hunch' or 'gut-feeling', rather that statement is based on real private market data.

This vanilla buyout strategy has performed especially well both during and after times of greater uncertainty since 2000. This is particularly the case if middle-market buyout performance is compared with returns which could have been generated by investments in public market strategies. Where does this land us?

Look no further than recent times—buyout category portfolios were up modestly in 2023, and that performance had fared quite well compared to choppier, publicly listed assets since the outset of 2022. Their relative outperformance tends to be greatest in more volatile times, and post-downturn vintage years can offer buying opportunities. Breaking this segment down further, the data tells us that middle-market-focused buyout exposure has the potential to create even greater long-term outperformance within a balanced portfolio.

Different private market offerings from which to choose

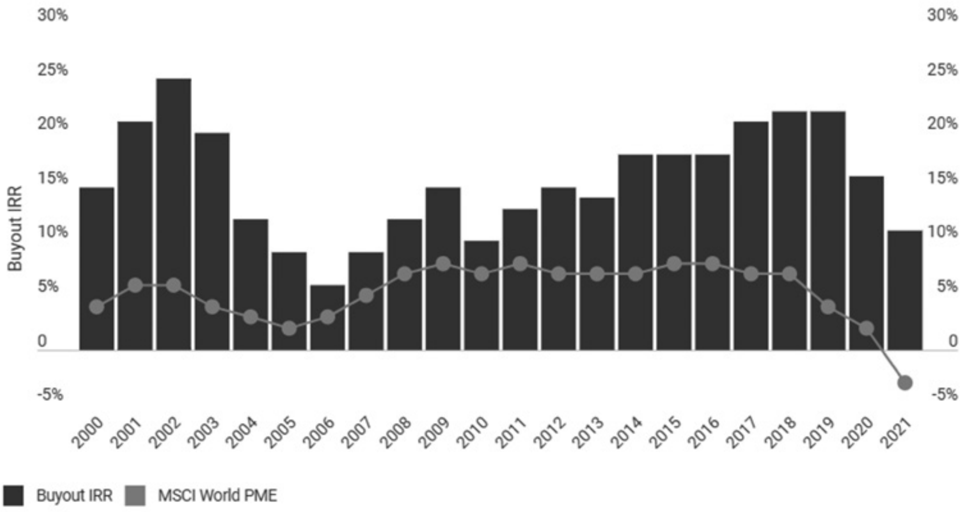
One of the benefits of modern private market offerings is that there are now many more flavours from which to choose. It is possible to build custom portfolios that account for risk, return, liquidity, duration and so many other factors that it can feel like building your own ice cream sundae from dozens of fund flavours. This is no longer your grandparents' asset class with buyout and venture as your only two choices. Investors have strategies upon strategies upon sub-strategies from which to choose.

In the last five to seven years, we have gone from a macroeconomic environment that focused on 'growth at any cost' to one in 2023 where a new normal of lower purchase prices has begun to re-emerge. Sound familiar? Of course it does. That is because profitability matters—just like it used to. This is an environment in which the governance model of private equity—the ability to control your destiny by actively managing the private company—really matters.

Another key point to acknowledge when looking backwards is 'data don't lie'. The perception of private equity performance during periods of stress was shaped by studies immediately following the Global Financial Crisis (GFC), which relied on nascent (and largely unrealised) data.

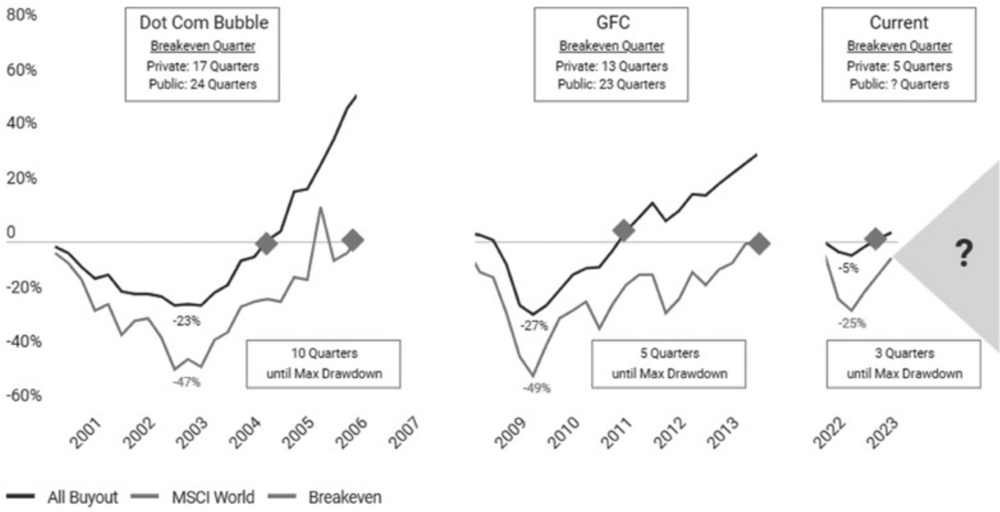
Questions asked during this time included, 'Are the valuations real? Is performance sustainable? Are the investor experiences likely to be

Figure 1. Buyout internal rate of return (IRR) versus public market equivalents
By vintage year



Source: Hamilton Lane data via Cobalt; Bloomberg (August 2023)

Figure 2. Cumulative returns during a crisis
Buyout versus global equities cumulative returns



Top line = all buyout
Bottom line = MSCI World
Square = breakeven

Source: Hamilton Lane data via Cobalt; Bloomberg (August 2023)

the same going forward?' The good news is that, this time around, we now have much more robust private market data. That data is now 'crystalised'; and buyout deals, assets and funds from those eras are nearly fully realised.

The outperformance of buyouts versus public market equivalents (PMEs) was particularly heightened in the post-dotcom and GFC vintage years (see Figure 1); not to mention that, for the left-hand side of Figure 1, these results and outperformance statistics are not hypothetical. They are predominantly actual, realised results at this point.

In light of today's macroeconomic environment, seemingly vanilla strategies (such as buyouts) have the potential to deliver impressive long-term results. During the 2000–2001 dotcom bubble and the 2007–2008 GFC, public market declines continued three-quarters past the

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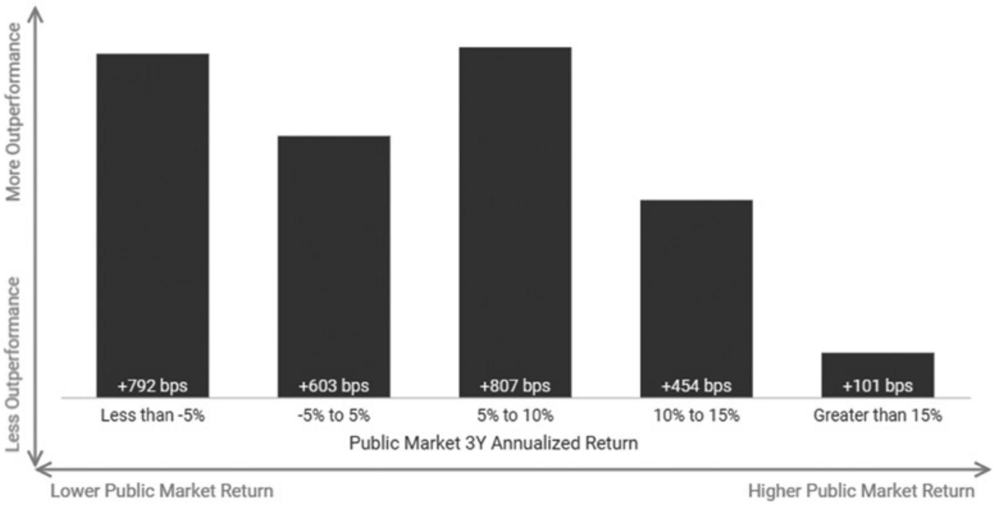
Figure 3. Performance by public market regime
All price-to-earnings average three-year excess return by S&P return regime



Source: Hamilton Lane data, Bloomberg (January 2023)

Annualised three-year returns from 1995–Q3 2002.
Past performance is not an indication of future results.

official end to the crises. Coming out of both, buyouts outperformed handily, moving way ahead of public market returns as markets started to regain their footing (see Figure 2 on the preceding page).

Since the market downturn began in 2022, buyout purchase prices have stayed below their 2021 peak while public equity prices have been volatile. In the near term, a sharp rebound in public prices has the potential to lead to a period where short-term private equity returns lag public market returns.

What should investors expect as we remain in a world where there is likely to be great volatility and continued uncertainties in the near term? Have a look at Figure 3. To revisit an oldie-but-goodie, data reflected in this Figure show that private equity's average net outperformance tends to be greatest when public markets exhibit more mediocre or negative returns. This counterbalance can moderate the impact of down years and potentially elevate total portfolio performance in the long run—depending, of course, on the deals and funds in a portfolio.

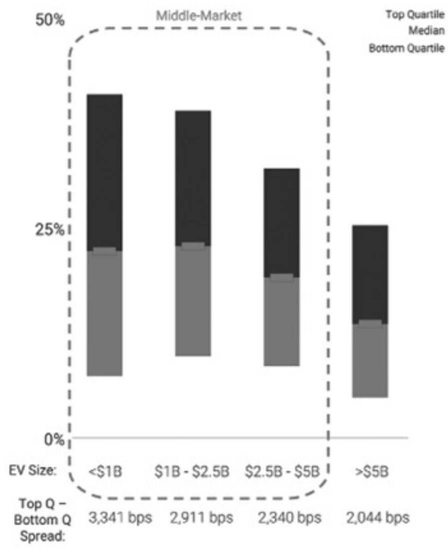
Does deal size matter?

Vintage Years: 2000–2020

Figure 4 examines gross internal rates of return at the buyout deal level by enterprise value (EV). It becomes evident that, on average, returns in the middle-market strategies have been consistently higher than those at the larger end of the deal spectrum. That makes sense, given that there is a much more robust and investable landscape in terms of the numbers of private middle-market companies globally.

In terms of trade-offs, there is clearly a wider dispersion of returns in this strategy, so the implications of

Figure 4. Buyout spread of gross IRR by EV
Vintage years: 2000–2020

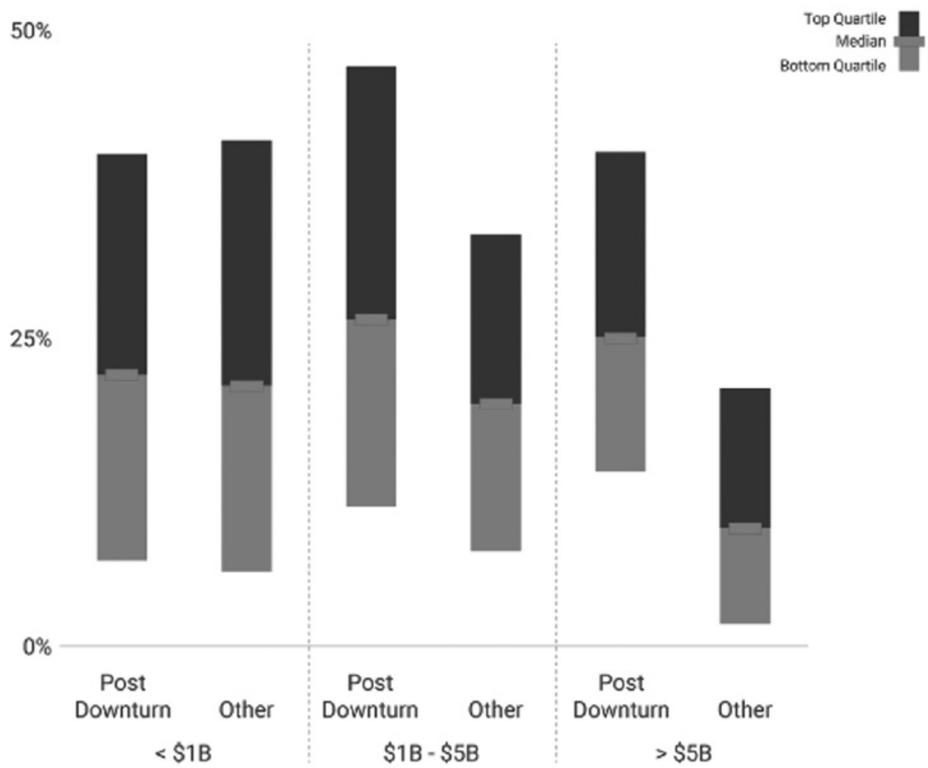


Source: Hamilton Lane data via Cobalt (October 2023)

building an adequately diversified exposure to this segment also remain critical. This is especially so, as most single funds targeting middle-market transactions tend to be more concentrated in terms of the number of transactions relative to the upper end of the market.

What is the source of that strong performance? A greater proportion of the total value created for small-to-mid-

Figure 5. Buyout spread of gross IRR by EV at entry
Vintage years: 2000–2018 + realised deals, post-downturn vintages versus other



Source: Hamilton Lane data (October 2023)

The quote

Vanilla strategies like buyouts—while not always the most 'exotic'—historically have performed well.

dle-sized assets is attributable to earnings before interest, taxes, depreciation, and amortisation (EBITDA) growth. That also makes sense—these mid-sized companies are less likely to be mature and have less likelihood of being intermediated or 'packaged' during a sales process.

This creates opportunities for savvy operators to accelerate product research and development, enhance sales techniques, streamline procurement and professionalise back-office functions. A strategic implementation of goals around new market channels, M&A opportunities, or other non-organic growth levers may also be available.

Thus, a buyer that can find these types of assets have multiple possibilities for value creation in a much more fragmented corporate segment with fewer institutionalised businesses. Here, the ability to strategically choose—and not settle on—investment opportunities from a target-rich environment has the potential to deliver attractive risk-adjusted returns.

This too shall pass

As we are likely in the midst of, close to, or already partially through an economic recession in most developed economies, we also must consider what the data tells us about performance with that type of macroeconomic and cyclical overlay. Once again, the middle-market segments—the two middle columns shown in Figure 5—demonstrate a compelling case for investment, especially in post-downturn vintage years based on historical data. In other words, these strategies fare well in an economic recovery.

Don't overthink it

Sometimes the best decision is the simplest. There is a reason why buyout-focused strategies constitute more than 40% of all private-market-focused capital and why they continue to be the predominant investment strategy. Vanilla strategies like buyouts—while not always the most 'exotic'—historically have performed well, especially in choppier economic conditions and especially relative to listed asset classes. **FS**