PRIVATE MARKETS INSIGHTS

THINK SMALL: WHY MICRO BUYOUT FUNDS SHOULD HAVE A PLACE IN YOUR PORTFOLIO

While market headlines tend to focus on everything "mega" – funds, deals, etc. – there is a segment within the private equity buyout universe where inefficiencies abound, competition for deals is lower, and highly skilled managers can add significant value. This corner of the market is populated by hundreds of thousands of target companies, many of which provide compelling products and services and are run by talented, committed management teams. And here's the kicker: This group has outperformed its counterparts in 9 of the last 13 vintage years.

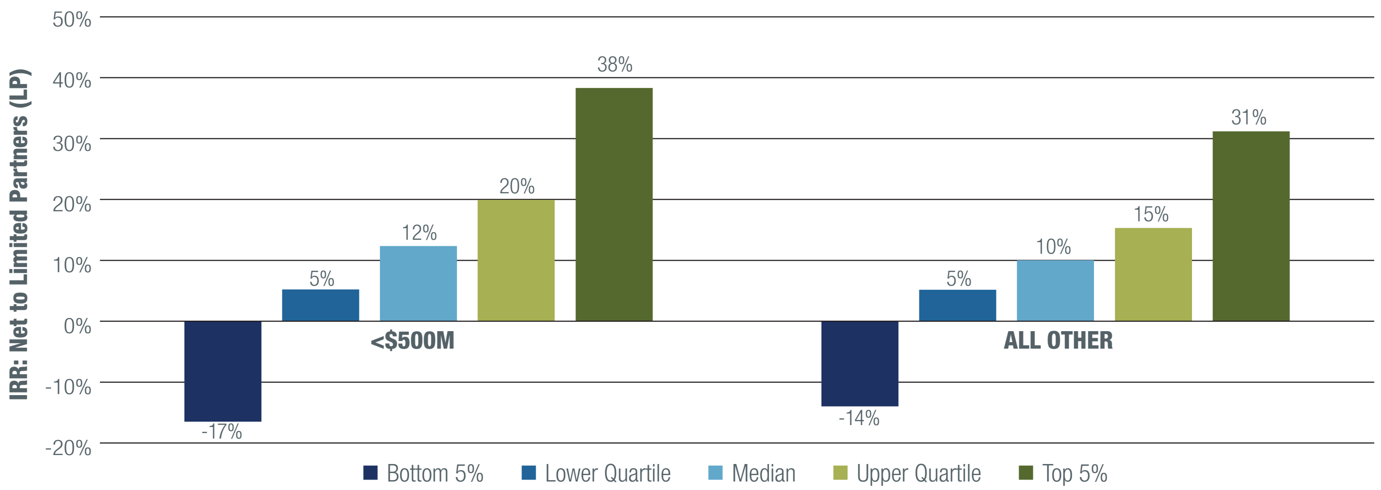
Micro buyout funds – defined as those that have raised $500 million or less – offer a very attractive risk/reward trade-off and can help strengthen and diversify existing private equity portfolios. But as with any other investment opportunity, the benefits and challenges must be weighed, and careful consideration needs to be given to how you will approach the market and gain access to deals.

ACCESSING DEALS

Because the return dispersions among small fund managers vary so widely, choosing to invest in a single manager can be fraught with risk. Instead, we encourage clients to invest in the smaller end of the market through a pooled fund, or separately managed account (SMA), where built-in diversification lessens the chances for idiosyncratic manager risk and can actually make the broad dispersion of returns work in your favor.

This is a classic finance 101 case of diversification leading to a lower combined risk than the individual risk associated with any single asset in the pool. This also allows for the opportunity for outperformance.

Chart 1: US Buyouts Return Comparison by Size



Source: Cambridge Associates, as of September 30, 2016
Vintage years 2005 and younger

WHY GO SMALL?

In this case, the old adage rings true: Good things do come in small packages. When stacked up next to all other size segments of the buyout market, US micro buyout funds have exhibited the highest outperformance across all time periods and quartiles. Upper-quartile micro buyout managers have generated a 20% net return to limited partners (LPs), compared to 15% for non-micro-sized buyouts (Chart 1). This outperformance also holds among the top-5% of managers, where micro buyout funds have provided a 38% net return to LPs compared to 31% for all other buyout funds.

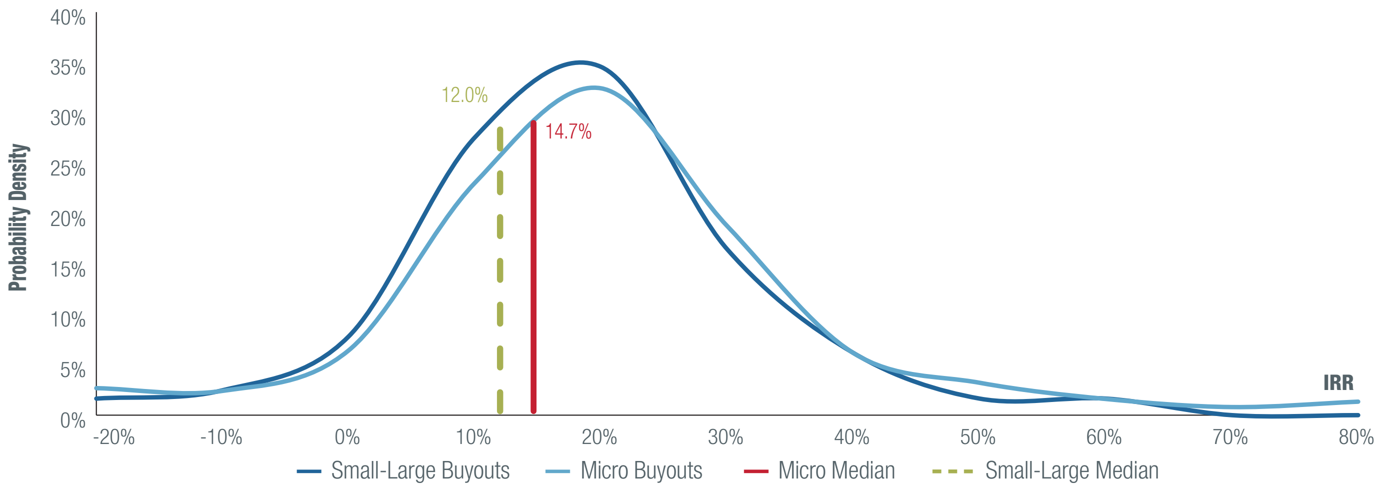
US micro buyout funds have also generated a higher median return of nearly 300 basis points relative to their peers, a gap that is both substantial and meaningful, particularly over time (Chart 2).

In the buyout universe, small US buyout funds have exhibited the highest outperformance across all time periods and quartiles.

The reasons for this outperformance are partly intuitive. Smaller companies drive value creation through management team upgrades, the enhancement of operational systems and improved metrics for tracking results, and the use of add-on acquisitions to drive revenue and EBITDA growth. Consequently, there is often greater potential for micro fund managers to increase the market penetration of the entities they acquire. Large and mega funds, on the other hand, focus on more established, larger companies, where most of the value realized often comes from restructuring or management changes rather than market growth. Pricing across the large and mega segments of the buyout market is also highly competitive.

Getting into the micro buyout market at appealing multiples is a key component in capitalizing on this potential outperformance, but this is just the tip of the iceberg in terms of tapping into the dynamic value creation prevalent across this segment. The key to long-term success ultimately lies in selecting the very best fund managers across all fund sizes, a task that can be much easier said than done.

Chart 2: US Buyouts IRR Distribution Comparison by Size



Vintage years 1995 to 2012; funds with residual value <20%; Micro cap = $500 million or less; Residual value = $1 - \frac{\Sigma \text{ Cumulative Distributions}}{\text{Total Value}}$
See Note 1 on page 4 for more details.

KNOW THE RISKS

While smaller funds have consistently outpaced their peers they also generate a much wider range of results than bigger funds, and this dispersion needs to be factored into your portfolio management strategy.

Relative to larger funds – which tend to be more proven and reliable because their target companies are more established and feature less risk – smaller funds bring much more complexity. The sheer volume of opportunities to sift through and analyze, for example, can be overwhelming compared to other buyout segments. At the same time, it can be very challenging to see the path forward for smaller funds trying to grow. Some are going to emerge as superstars, some will be solid, long-term performers, and others will inevitably lose their way.

SPECIALIZED EXPERTISE

By no means are we suggesting that you replace your core private equity portfolio with a micro buyout strategy. However, if you want increased access to the alpha these opportunities can generate, doing so through a complementary sub-portfolio could be highly additive to your broader allocation. Similar to public market diversification strategies, adding some micro exposure into a blended mix of mid- and large-cap buyout funds increases portfolio returns while reducing the risk of capital loss.

That said, the challenges in navigating this sprawling but rewarding market can be daunting or even downright impossible for many investors. In the end, success in the micro buyout space hinges on dedicated experience and a proven, comprehensive due diligence process.

HarbourVest has 18 investment professionals focused exclusively on the US buyout market, which includes specialized expertise in the micro buyout segment.

Comprehensive due diligence is key – some micro buyout funds will grow into superstars, some will be solid long-term performers, and others will inevitably lose their way.

HARBOURVEST

KEY TAKEAWAYS

Micro buyout funds exemplify the concept of risk and reward. The rewards are clear: this segment of the market has a strong track record of outperformance, and adding micro exposure to your existing private equity allocation will enhance the overall diversification of your portfolio. But the risks and challenges of operating in this space need to be carefully calibrated with the benefits. The micro buyout universe is a large one filled with a wide range of opportunities, and finding the best ones requires both expertise and patience.

Note 1 (Chart 2): These model (hypothetical) portfolios are intended for illustrative purposes only. Performance information for each hypothetical portfolio utilized a Monte Carlo simulation and is based on the actual cash flows of a proprietary data set that includes partnership investments made by HarbourVest Funds and accounts, along with partnership data from external sources. The capital calls and distribution data is based on historic partnership investment cash flows, but does not represent the actual experience of any investor or any HarbourVest fund. The results of the simulation are impacted by an uneven representation of funds with different vintage years, sizes, managers, and strategies, and a limited pool of investment cash flow data. The actual pace and timing of cash flows is likely to be different and will be highly dependent on the underlying partnerships' commitment pace, the types of investments made by the fund(s), market conditions, and terms of any relevant management agreements. The results presented are based entirely on the output from numerous mathematical simulations. The simulations are unconstrained by the fund size, market opportunity, and minimum commitment amount, and do not take into account the practical aspects of raising and managing a fund. The simulated hypothetical portfolio results should be used solely as a guide and should not be relied upon to manage your investments or make investment decisions. Past performance is not a guarantee of future returns, and there can be no assurance that future funds or accounts will achieve comparable results. Investments in private funds involve significant risks, including loss of the entire investment.

Beijing | Bogotá | Boston | Hong Kong | London | Seoul | Tel Aviv | Tokyo | Toronto
www.harbourvest.com