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IN FOCUS

The attractions of the small-mid private equity segment

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New empirical research from Schroders Capital reveals that small and mid-sized private equity funds have outperformed large funds with greater resilience through economic cycles.

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As the private equity market has grown over the past few decades, large funds have attracted an increasingly large share of overall limited partner (LP) capital. Investors have gravitated towards large private equity funds under the assumption that they offer better returns and resilience due to scale and stability.

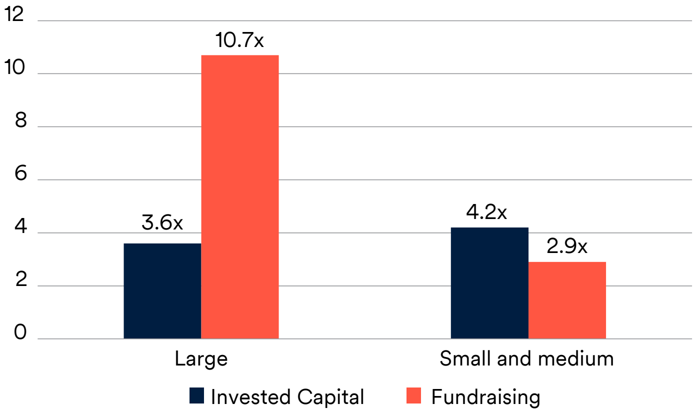
Our analysis shows that small and mid-sized private equity funds have, in fact, outperformed their large counterparts with more robust and persistent returns through time. Moreover, with the small- and mid-segment contributing the vast majority of opportunities in private equity, we believe investors should not overlook this valuable portion of the market.

Small- and mid-sized funds – favourable fund raising dynamics

We have analysed data from over 49,000 private equity funds and 200,000 deals in buyout, growth, and venture capital from 1980 to 2022 (for the purpose of performance analysis, we have excluded fund vintages beyond 2017, where performance is likely not stable. Single-deal funds and funds of funds excluded. Deals below $1 million are excluded). We classify the small and mid-sized segment as funds under $500 million and $2 billion respectively and deals under $50 million and $200 million respectively. The data presented hereafter encompasses all regions and strategies, unless otherwise stated.

Over the last decade, fund raising by large funds has far outpaced deal flow, resulting in higher competition and thus entry multiples for large deals. Large deal flow has grown at 3.6x, while fund raising from large funds has grown at 10.7x. Small and mid funds, by contrast, have experienced 4.2x growth in annual deal flow over the last decade, while annual fund raising has grown at just 2.9x.

Fund raising growth vs. invested capital growth 2010–2022



Source: Preqin, Schroders Capital, 2023.

Not only is the pace of fund raising growth much higher in large funds, fund raising levels are already far above the long-term trend, according to the Schroders Capital Fund Raising Indicator (FRI). The FRI is a Schroders Capital proprietary model that shows the areas of the private equity market that are above or below long-term fund raising levels. The long-term trend is based on fund raising levels adjusted for inflation and excludes business cycles. Excessive amounts of capital leads to more competition for deals, higher prices being paid and, ultimately, likely worse returns.

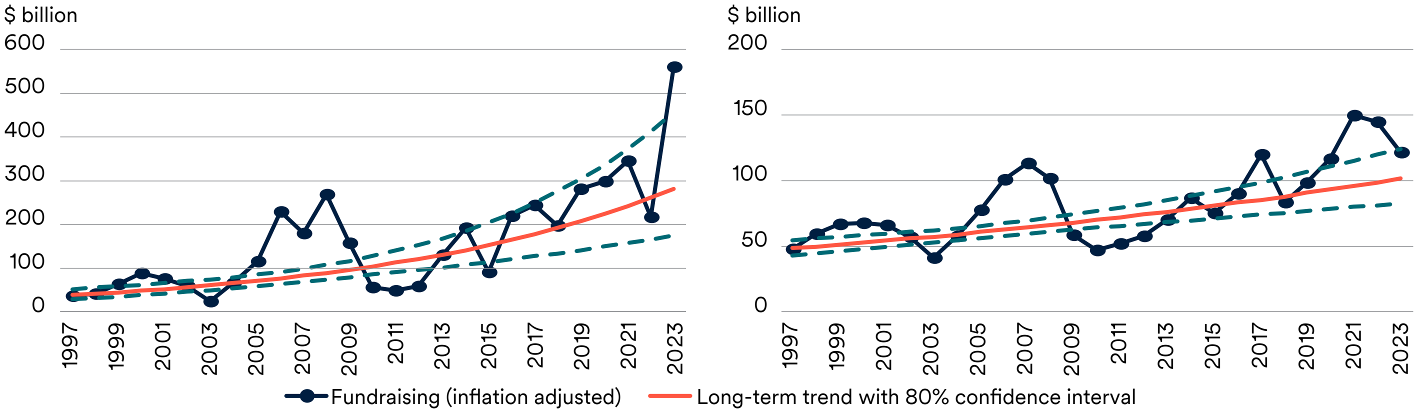
Read more: Four perils for private equity now, and what they mean for new investments

Schroders capital

We currently observe that fund raising in European and North American large buyout funds is 100% above the long-term trend compared to only 20% above trend in small and mid buyout funds.

Schroders Capital Fund Raising Indicator, Europe and North America Buyout

Large buyout rolling 12 month fund raising and long-term trend | **Small and mid buyout rolling 12 month fund raising and long-term trend**



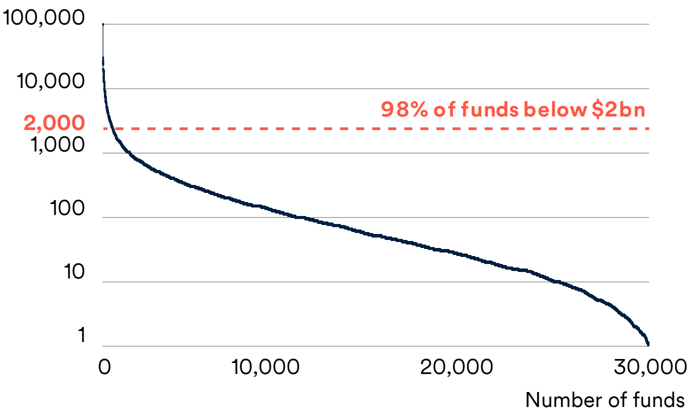
Source: Preqin, Schroders Capital, 2023. Fund raising numbers shown include Europe and North American buyout funds excluding fund of funds and secondaries. Large buyouts: Funds >$2bn. Small/mid buyouts: Funds <$2bn. Based on last 12 months data for every year as of end of September each year. Current market trends are not a guide to future results and may not continue.

The "long tail" of private equity

Historically, the small and mid segment of the market has offered far more investment opportunities in both funds and deals.

According to Preqin data from 2010 to 2022, there have been 40x more small and mid funds in the market than large funds, and 15x more small and mid deal opportunities than large deals. In other words, the small and mid segment makes up the bulk of the "long tail" of private equity, accounting for 98% of all funds in market and 90% of all deals.

Long tail of Private Equity funds 2010–2022
Fund size ($m)



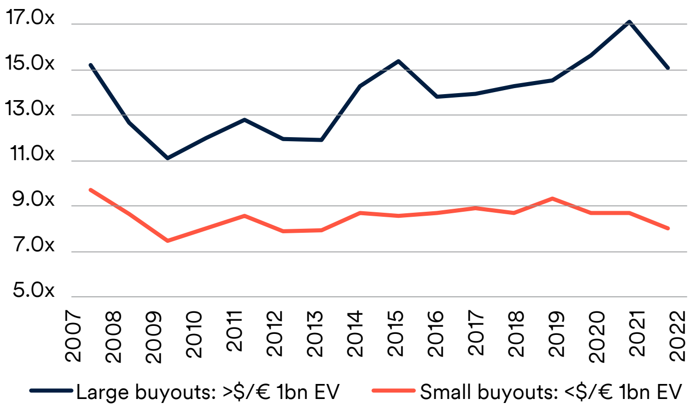
Source: Preqin, Schroders Capital, 2023. Shown for illustrative purposes only and not investment guidance.

Entry multiples are more attractive in small- and mid-sized deals

Tracking EV/EBITDA multiples over the long-term shows a consistently wide discount between mid-market and large buyout deals (which today stands at around 5–6x).

This can in part be explained by the more favourable dry powder situation in the mid-market. But this is also due to higher perceived risk in small and mid-sized deals, where smaller companies may be less diversified and professionalised. Small and mid-sized deals are also often sourced through proprietary networks rather than through competitive auctions.

Buyout EV/EBITDA purchase multiples, Europe and North America



Source: Schroders Capital, Capital IQ, Baird Global M&A Report. EV/EBITDA multiples include transactions in Europe and North America. Past performance is not a guide to future results.

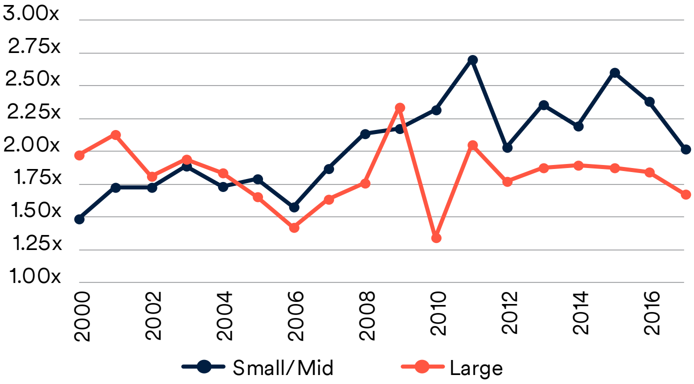
Small and mid-sized funds have delivered higher returns than large funds

On average, small and mid-sized private equity funds have outperformed large private equity funds on a net total value paid in (TVPI) basis for vintages after 2005 and on a net internal rate of return (IRR) basis for vintages after 2009.

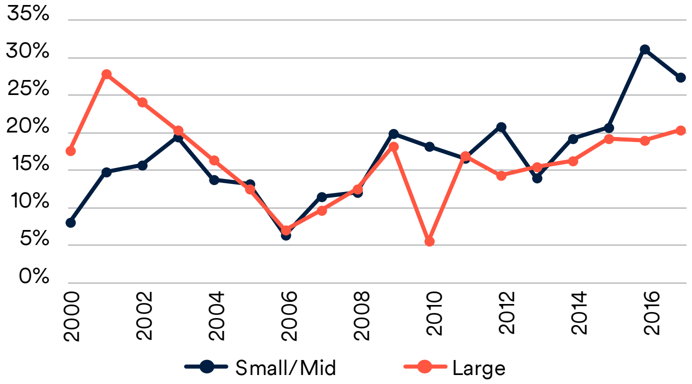
The outperformance is also demonstrated consistently across different geographic regions and investment strategies. Across Asia, North America and Europe, small- and mid-funds delivered higher net returns than large funds between 2000 and 2017. Small and mid venture, growth and buyout funds also outperformed their large counterparts.

Average TVPI and IRR by fund vintage

Average net TVPI



Average net IRR



Source: Preqin, Schroders Capital, 2023. Performance numbers are net to investors. Past performance provides no guarantee of future results and may not be repeated.

Despite their attractive return profile, small- and mid-funds present a different risk profile compared to large funds. To assess this, we compared the inter-quartile ranges (IQR) of small and mid funds to that of large funds. Small and mid funds showed a wider IQR with higher top quartile and lower bottom quartile performance than large funds. A practical consequence of this finding suggests that LPs should apply rigorous due diligence and fund selection skills when selecting small- and mid-fund portfolios.

Small and mid fund returns – more resilient through economic cycles and more persistent through fund vintages

We assessed returns by fund size during two recessionary periods: the Great Financial Crisis (2007–2009) and Dotcom bubble (2001). We found that small and mid funds delivered higher returns than large funds in terms of both net TVPI and net IRR (below).

Small- and mid-funds are also better at maintaining good performance over subsequent fund vintages than large funds. In 2022, we conducted research that showed evidence of persistence of returns in small and mid funds but not in large funds.

Read more: Is there persistence in private equity returns?

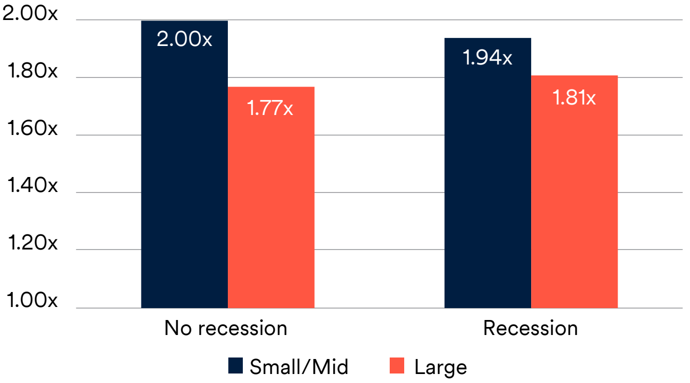
The research showed that the persistence of returns is greatest among small funds, strong and significant among medium-sized funds, but weak among large ones. In particular, 36% of small and mid private equity funds that were top quartile in one vintage were top quartile in the GP's next vintage. This is only 22% amongst large funds.

Broader, more attractive opportunity set

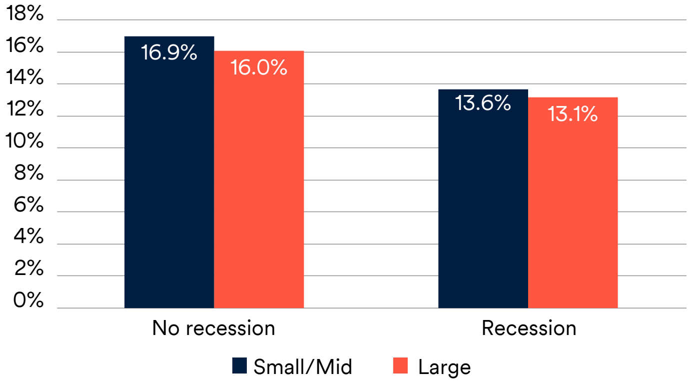
Investors have traditionally favoured large private equity funds. However, small and mid-sized funds have outperformed their large counterparts across different regions, investment strategies, and economic periods. This can be partly attributed to the fact that companies targeted by small and mid-sized funds often transact at lower valuation multiples. They also offer greater potential for operational value creation and are attractive prospects for larger private equity funds or strategic buyers seeking "tuck-in" investments. Particularly in an era where large private equity funds are flush with capital, we believe the small and mid-sized segment offers a broader and more attractive set of investment opportunities.

Performance during periods of recession

Average net TVPI



Average net IRR



Source: Preqin, Schroders Capital, 2023. Period covered 2000–2017. Performance numbers are net to investors. Past performance provides no guarantee of future results and may not be repeated.

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