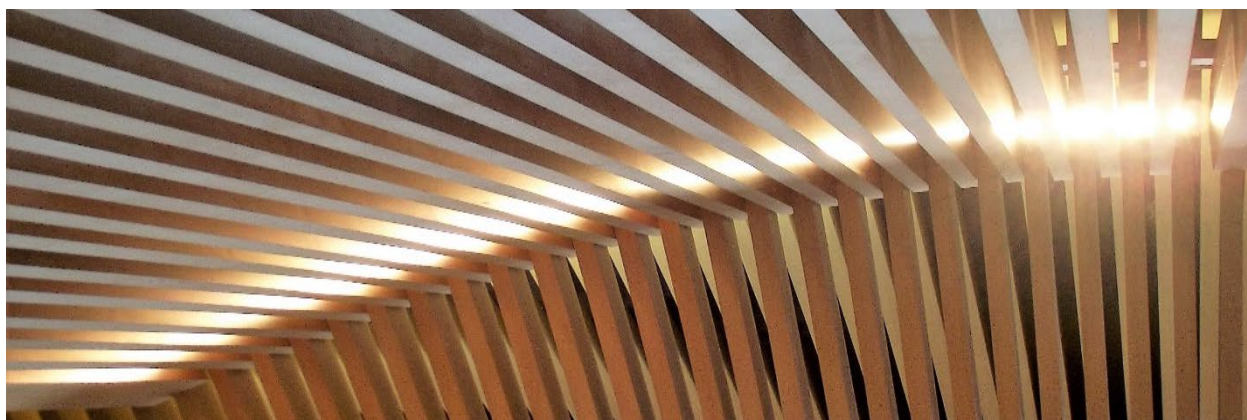


## DO SMALL BUYOUT FUNDS STILL BELONG IN A DIVERSIFIED PRIVATE EQUITY PORTFOLIO?



Institutional investors seeking private equity exposure aim to capture perceived or expected outsized returns, yet can struggle with the question of how best to construct that portfolio. CIOs and their staff often face resource constraints, which can hinder sourcing and diligence efforts, as they try to review numerous investment opportunities and maintain investment discipline, as well as meet risk and return objectives. In light of these constraints, some have pursued a 'flight to quality' by making fewer and larger commitments focused mainly on larger buyout funds.

The private equity market, however, has experienced an explosion of small buyout funds. If private equity is a niche within many institutional portfolios, investing in small buyout funds is a niche within that niche. According to Preqin, the average number of small buyout funds per vintage year between 2000 and 2019 was 219. From 2020 through the end of 2022, the average number of small buyout funds per vintage year increased by nearly 150%, to 530. Given the increased volume of funds to review, investors may ask whether they should invest the time and energy into finding small buyout funds for their portfolio. After looking at year-end 2022 return data from Preqin for buyout funds (VY 2000-2019), Abbott believes that small buyout funds (with commitments of \$1B or less) continue to provide a potential for relative outperformance versus the universe of larger buyout funds (with commitments above \$1B), and anticipates that small buyout funds will remain an important component of a diversified private equity portfolio.

### ***What are the practical challenges facing institutional investors when trying to access the small buyout market?***

Before diving into the data supporting the potential for outperformance, there are several practical considerations and constraints that investors face in accessing this segment of the market. At the outset, we believe it is important to acknowledge the very real differences that exist among institutional investors.

At the most basic level, the size of an investor's private equity portfolio and, thus, the resources an investor has available, often presents the most obvious challenge. Investors with less capital to deploy may decide an allocation of resources to small buyout funds could be additive to their portfolio but lack the staff and relationships to appropriately source and diligence these managers. On the other end of the spectrum, very large institutional investors may have the resources to diligence these groups, but find, due to the velocity at which they need to deploy capital, that the small buyout market is too inefficient.

Access and investment restrictions – two sides of the same coin – can also impact an investor's decision to pursue an allocation to a small buyout strategy. Small buyout funds are, by definition, small, and fund managers may place a cap on the amount they make available to a single investor. Similarly, an investor may have constraints on the total percentage of a fund they wish to represent. Investors with a desire to invest larger amounts may find that they are unable to commit as much capital as they would like to a single fund or to the strategy as a whole. These large institutional investors might then conclude that the performance potentially generated by small buyout funds isn't sufficient to have a material impact on the performance of their overall private equity portfolio, resulting in the choice to overweight allocations to larger buyout funds.

Even before access becomes an issue, investors must find and evaluate a large (and as noted above, growing) number of potential fund managers. This presents a challenge even to large investment teams. An investor without sufficient scale to maintain relationships with multiple small buyout managers across cycles may become overwhelmed, especially if they lack dedicated systems and processes to manage the volumes of data. Regular interaction, potentially over several years, to build relationships and monitor progress may be necessary to gain access to and build conviction around a manager's next fund.

Access, resources, and capital deployment considerations are all viable reasons that continue to drive certain investors to focus on larger buyout funds. In the fall of 2020, Abbott initially examined the relevance of small buyout funds in a diversified alternatives portfolio versus a focus on larger buyout funds. Three years ago, we concluded that, "While larger private equity funds may be able to provide a certain level of consistent performance, the range of returns ... is banded. Smaller funds, while often considered higher on the risk curve due to greater volatility of returns, may have an increased potential to contribute stronger returns to an investor's overall portfolio." Given the changes in the market environment since 2020, and the trend of some institutional investors to focus on the larger end of the buyout market, Abbott decided to re-examine this prior assessment. Abbott continues to believe there is evidence of outperformance potential within the small buyout segment of the alternatives market.

### ***What metrics were used to assess performance expectations for small buyout funds?***

Historical dispersion of absolute returns provided one metric for assessing outperformance. The chart below represents Preqin's VY 2000-2019 buyout fund universe and illustrates that the subset of small buyout funds continued to generate a wider dispersion of returns when compared to the subset of larger buyout funds.

**Figure 1: Net TVPI by Fund Size - All Buyout Funds (VY 2000-2019)<sup>1</sup>**

As of Dec 31 2022



This potential for higher returns is interesting, but not definitive. When we examined the returns of the same universe of funds using benchmark quartile data, the historical relative outperformance of this subset of small buyout funds also held true. The Net IRR and Net TVPI cutoffs for median (18.4% | 1.80x) and top quartile (27.1% | 2.34x) performance of small buyout funds as of year-end 2022 exceeded the cutoffs for median (16.2% | 1.69x) and top (22.9% | 2.02x) quartile performance of the larger buyout funds. Simply put: the median small fund outperformed the median larger fund.

**Figure 2: Quartiles - All Buyout Funds (VY 2000-2019)<sup>1</sup>**

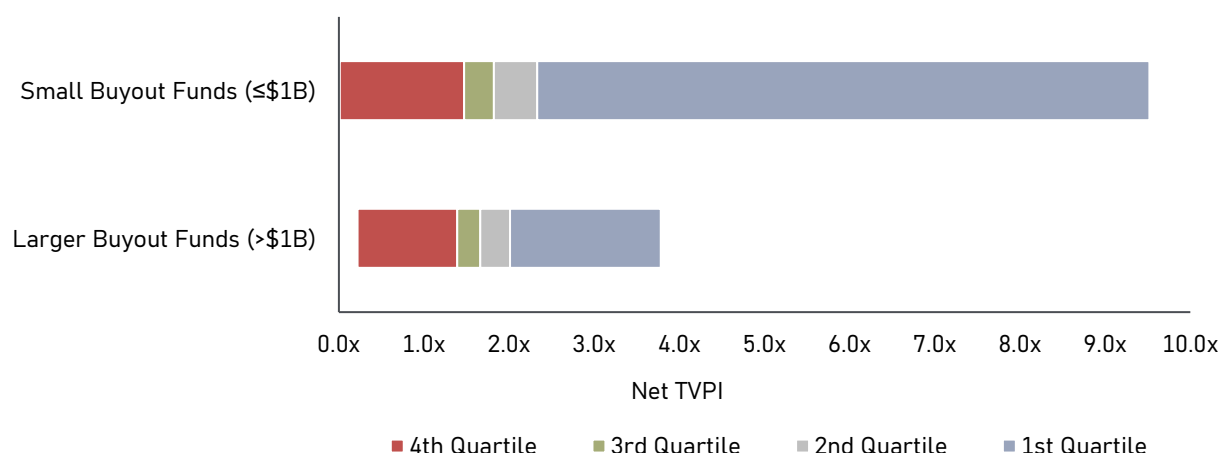
As of Dec 31 2022

Fund Size	NET IRR			NET TVPI		
	Bottom Quartile	Median	Top Quartile	Bottom Quartile	Median	Top Quartile
Small Buyout Funds (≤\$1B)	10.0%	18.4%	27.1%	1.43x	1.80x	2.34x
Larger Buyout Funds (>\$1B)	10.7%	16.2%	22.9%	1.40x	1.69x	2.02x

Abbott also examined performance associated with just the subset of funds formed in the “modern” era, i.e., those funds formed during and following the Great Recession (VY 2008-2019). This subset of small buyout funds also generated comparable outperformance by Net TVPI and a wider dispersion of returns than the broader universe.

**Figure 3: Net TVPI by Fund Size – All Buyout Funds (VY 2008-2019)<sup>2</sup>**

As of Dec 31 2022



As Figure 3 shows, investors in small buyout funds between 2008 and 2019 who only succeeded in selecting median performance approached a 2.0x Net TVPI. By contrast, investors in larger buyout funds needed to select top quartile funds to generate a similar level of performance.

Similarly, when evaluating an even shorter time period, during and immediately following the Great Recession (VY 2008-2011), small buyout funds had a first quartile minimum and maximum higher than that of the larger buyout funds over the same vintages. One potential explanation for this disparity could be the often-reported theory that smaller companies that survive a recession can experience accelerated growth or more significant revaluations during the subsequent economic recovery than their larger peers.

**Figure 4: First Quartile Net TVPI Range – All Buyout Funds (VY 2008-2011)<sup>3</sup>**

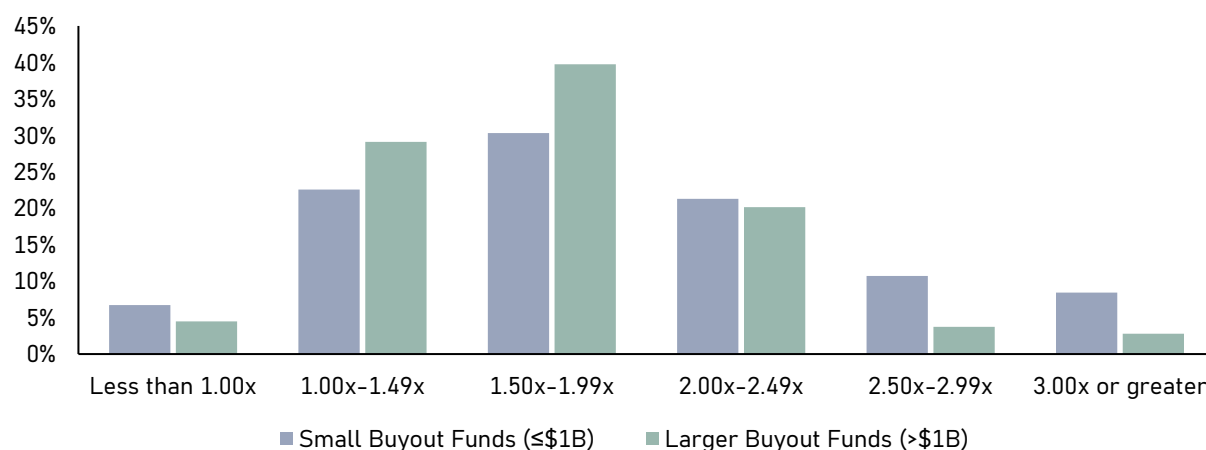
As of Dec 31 2022

	1 <sup>st</sup> Quartile Minimum	1 <sup>st</sup> Quartile Maximum
Small Buyout Funds (≤\$1B)	2.50x	9.52x
Larger Buyout Funds (>\$1B)	2.08x	3.78x

We also plotted the distribution of returns and found, consistent with our prior analysis, that the larger buyout funds demonstrated a more classic bell curve with a tall middle that peaked with approximately 40% of larger buyout funds generating a 1.5x-2.0x net TVPI. Small buyout funds, in contrast, continued to exhibit a flatter curve. Smaller funds did fail to return capital at a higher rate than their larger counterparts, but they also dominated the long, right tail with a much greater percentage of funds returning 2.0x or greater (40% for the small buyout funds versus only 27% for the larger funds).

**Figure 5: Net TVPI Distribution – All Buyout Funds (VY 2000–2019)<sup>1</sup>**

As of Dec 31 2022



As we observed in 2020, private equity investors with a conservative strategy seeking stable but banded returns might focus primarily on the larger buyout funds given that 69% of these funds generated 1.0x–2.0x, and only 4% returned <1.0x as observed above in Figure 5. However, if there is indeed greater potential for outperformance by small buyout funds, private equity investors may be able to benefit from capturing the upside possibilities exhibited on the right side of the chart above, as long as they can adequately mitigate the risks and avoid too much exposure to the funds on the left.

### ***Why do small buyout funds exhibit this historical outperformance?***

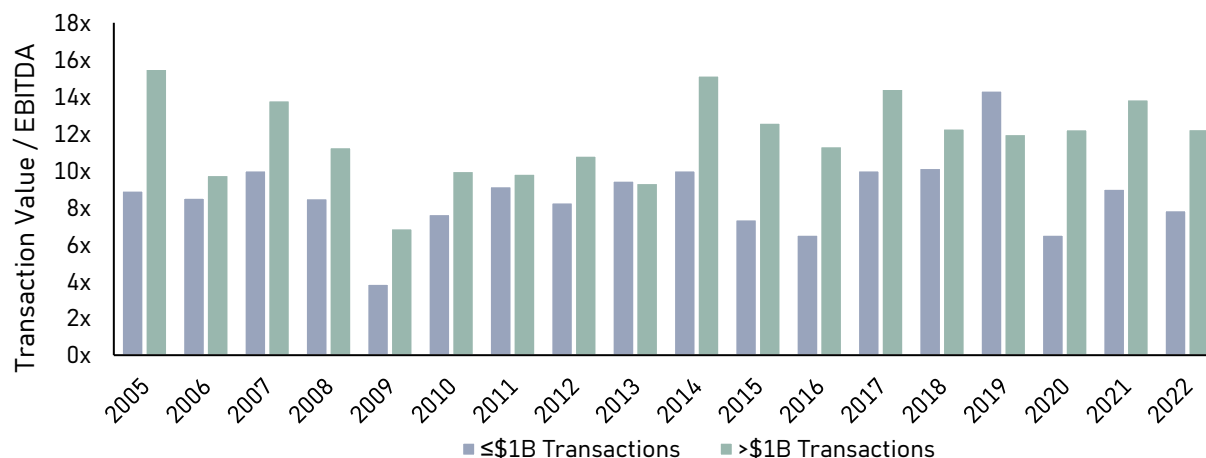
Abbott believes that much of the historical outperformance by small buyout funds may stem from the inherent inefficiencies in many small businesses. Some of the challenges and opportunities facing smaller companies exist in all types of economic environments. Small buyout managers who can address the following conditions effectively and consistently may unlock significant growth and value creation:

- Limited risk appetite of a business owner whose net worth may be tied to the company
- Limited access to capital to invest in organic and inorganic growth
- An underdeveloped management team that may be inexperienced in:
  - Driving transformative growth
  - Executing M&A
  - Opening new geographies
  - Utilizing a full financial toolkit
- Challenges attracting high quality talent to a small, potentially undercapitalized business
- Underinvestment in IT systems and control functions
- Insufficient data and understanding to introduce new products or increase pricing

Small businesses exhibiting these factors often may be acquired at purchase price multiples lower than larger companies with greater size, scale, and expertise. A small buyout fund manager with the ability to address one or more of these limitations has the opportunity to benefit from transforming a smaller company purchased at a lower multiple into a larger one, which can then ideally be sold at a multiple reflecting both enhanced earnings and continued growth potential.

**Figure 6: Median Purchase Price Multiples – U.S. Buyout Deals<sup>4</sup>**

As of Dec 31 2022



In addition to the challenges referenced above, smaller businesses can trade for lower multiples due to a variety of other reasons:

- Geographic concentration
- Customer concentration
- Complicated ownership structure
- Lack of intermediary coverage and less sophisticated sellers
- Starved corporate orphans which would require substantial effort to create as a standalone business

When a small buyout manager is successful in scaling a smaller business into a more institutional or sizeable entity, the sale multiple is likely to increase as a new buyer can value the strategically more important asset with more stability and fewer risks. Many savvy small business owners recognize the constraints they face, and seek growth-oriented investors to help address their challenges. When owners sell only a portion of their business to “the right partner” who they believe can help scale their company dramatically, they may accept a lower initial purchase price. They do this with the hope that in the future, their share of a larger, more stable, more professional business will be worth even more.

### ***Is an investment in a small buyout fund more risky or volatile?***

Having reviewed the potential for outsized returns, Abbott turned its attention to risk by evaluating portfolio company loss rate (capital lost versus dollars invested). Since this data is less readily available, Abbott analyzed the portfolio company loss rates attributable to buyout funds in our clients’ portfolios (VY 2000-2015) as of March 31, 2023. The larger buyout funds had an aggregate portfolio company loss rate 2.6 percentage points lower than the loss rate for small buyout funds. That represented nearly a 14% difference in loss rates. This analysis, while reflecting portfolio company loss rate rather than net fund returns, does help explain the information represented in Figure 1, where there are a larger number of small funds below 1.0x. It is also consistent with Figure 3 (the larger red area extending toward 0.0x), and with the first two bars (0.0x-1.0x) shown in Figure 5.

Small buyout funds, on the whole, could be considered more risky than larger funds. Left tail risk, that is, underperformance or loss of capital, appears more common with small funds. Investors should consider for themselves whether the upside potential that small buyout funds offer is sufficient compensation for that risk. If the answer is yes, they should also consider how best to mitigate that downside risk.

### ***So is investing in a small buyout fund a worthwhile exercise?***

We believe the buyout market is more dynamic than it has ever been with many more new groups to evaluate. Despite the challenges faced by investors seeking access to the small buyout sector, Abbott continues to believe that the potential for outperformance by investing in small buyout funds outweighs the challenges and associated risks.

We believe that small buyout funds play an important role in many private equity portfolios, and provide valuable diversification away from their larger peers, while also offering the potential for greater returns. Investors must recognize, however, that *potential* for greater returns comes with risks. Applying ways to mitigate those risks may help avoid the left tail and move an investor into the long, right tail of outsized performance. Small can be beautiful.

#### **ABOUT ABBOTT**

Abbott Capital Management, LLC was founded in 1986 with the objective of providing long-term continuity and accountability in private equity portfolio management. As an independent investment adviser specializing in the creation and management of private equity investment programs, Abbott manages assets for a global investor base comprised of public, corporate, and multi-employer pension funds, foundations, endowments, family offices, and high net worth individuals.

## **SOURCES**

<sup>1</sup> Preqin. Data sourced 9/5/2023.

<sup>2</sup> Preqin. Data sourced 9/7/2023.

<sup>3</sup> Preqin. Data sourced 9/6/2023.

<sup>4</sup> PitchBook. Data sourced 9/6/2023; Includes deals with a minimum deal size of \$25M.

Preqin fund return data is compiled using FOIA and voluntary data contributions from more than 12,000 fund managers, and more than 10,000 funds. Preqin defines VY as the year the fund made its initial capital call or investment, while Abbott defines VY as the year the fund made its initial capital call. Preqin data is periodically updated and therefore subject to change.

PitchBook actively tracks all known PE deals in North America, Europe, and Israel regardless of transaction date with a focus on deals occurring from 2000 until the present and PE deals for companies located in Asia Pacific region (APAC), Middle East, North Africa, and Turkey and Latin America from 2015 to the present. PitchBook's data set includes more than 290,000 private equity deals, globally. PitchBook data is periodically updated and therefore subject to change.

Benchmarks or other measures of relative market performance are provided for information only and do not imply that an Abbott Client will achieve, or should expect, similar returns, volatility or results, or that these are appropriate benchmarks to be used for comparison. The market volatility, liquidity and other characteristics of private equity investments are materially different from publicly-traded securities and the composition of these indices does not reflect the manner in which any Abbott Client portfolio is constructed with respect to expected or actual returns, portfolio guidelines/restrictions, investment strategies/sectors, or volatility, all of which change. Index returns will generally reflect the reinvestment of dividends, if any, but do not reflect the deduction of any fees or expenses which would reduce returns. An investor cannot invest directly in the indices.

Loss rate information herein is compiled by Abbott as of March 31, 2023, and is unaudited, and does not represent the actual loss rate of any Abbott Client. Abbott aggregated loss rates for investments, made on behalf of Abbott's discretionary accounts managed as of March 31, 2023, in funds with vintage years 2000 through 2015 in Abbott's Small Buyout and North America Private Equity strategies. Abbott defines Small Buyout funds as buyout funds seeking to raise up to \$1 billion in aggregate commitments, while Abbott defines North America Private Equity funds as buyout funds seeking to raise over \$1 billion in aggregate commitments. Loss rate should not be considered indicative of Abbott's portfolio construction skill. The individual holdings and actual portfolio of each Abbott Client differs significantly. Loss rate calculations regarding an investment strategy or portfolio investment may not accurately reflect the current or expected loss rate of the strategy or Abbott Client. Such loss rate data should not be used to compare loss rates among multiple private equity funds due to, among other factors, differences in vintage year, investment strategy, investment size, etc.

## **IMPORTANT INFORMATION**

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