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PANTHEON PERSPECTIVES

**THE MID-MARKET
HOW PRIVATE
EQUITY'S 'ENGINE
ROOM' CAN
DRIVE ALPHA**





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The mid-market: How private equity's 'engine room' can drive alpha

“It is in the mid-market that the vast majority of private equity activity takes place – in terms of the number of companies that exist as potential investment opportunities, the number of deals that get done, and the number of funds that are raised each year.”

Too often, at least in popular consciousness and in the press, the term “private equity” is conflated with the large-cap end of the market; the multi-billion-dollar buyouts and take-privates of highly visible, well-known companies. Given the price tags and significant levels of leverage that are typically involved, there can be a resulting assumption (albeit not always a fair one) that returns in private equity are predominantly driven by limited levers such as financial engineering and rationalization of cost base.

However, and notwithstanding the attention that larger transactions receive, the reality is that the “engine room” of private equity is and always has been the small and middle market (in this paper referred to simply as the “mid-market”). It is in the mid-market that the vast majority of private equity activity takes place – in terms of the number of companies that exist as potential investment opportunities, the number of deals that get done, and the number of funds that are raised each year.¹

Transactions in the mid-market are typically buyouts of, or growth equity

investments into, founder-led or family-owned businesses, completed at lower entry multiples and, in the case of acquisitions, funded with modest debt packages. Most importantly, in our view, there are multiple pathways and operational levers to generate value for investors through these investments – and more attractive and flexible exit options to realize that value.

Importantly, given the sheer breadth and scale of the mid-market, it is a segment with a high degree of variance in company quality and strategies that fund managers (general partners, or “GPs”) can employ to create value. This means, as we will show, that returns tend to vary more widely than they do in the large-cap segment of the market – but, equally, that this is the segment of the private equity universe where historically the best returns have been found. Consequently, careful manager selection is critical to realizing the potential of mid-market investing.

¹ “Small and middle market” is characterized by several criteria which include, but are not limited to, one or more of several key company (annual revenues of up to \$1bn), deal (enterprise values of up to \$2.5bn) and fund (size of up to \$5bn) characteristics. The specifics may vary among industry professionals and can vary considerably at analysts’ discretion.

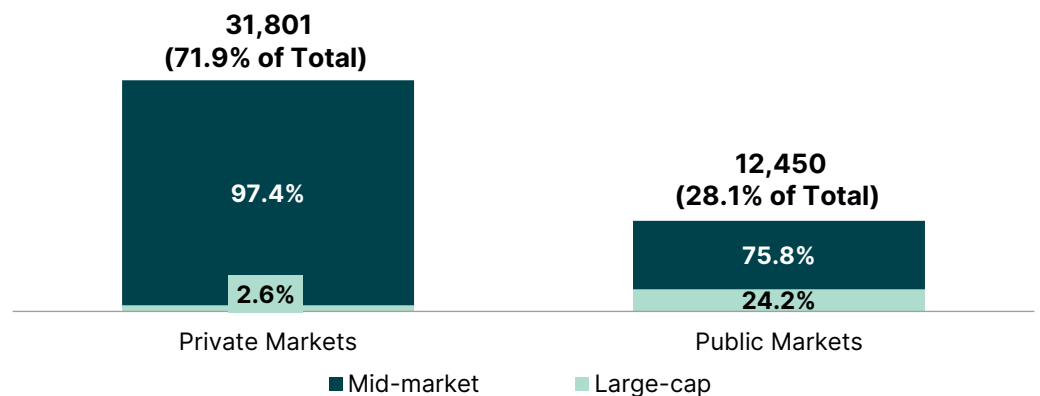


A huge opportunity set – with a relatively smaller capital pool

By company count, the investable opportunity set in the mid-market is massive. If you were to combine both the private and public markets, mid-market companies would represent over a 10:1 ratio in terms of the number of underlying investable companies relative to the large end of the spectrum. In the private markets across the US and Europe, ~97% of the

investable opportunity set falls into the mid-market space. Given the sheer number of companies available to mid-market managers, it isn't surprising that, between 2013 and 2023, ~97% of all buyout deals in the US and Europe happened in the mid-market.² Meanwhile, ~98% of private equity funds raised in that period were in the mid-market.³

Figure 1:
The company universe is dominated by the mid-market⁴



But despite the size and breadth of the universe of companies, investments and funds in the mid-market, there is a similar amount of dry powder waiting to be deployed as at the larger end of the market. Current dry powder (\$698bn) is near its record level in the mid-market – and end-of-year numbers topped \$700bn in each of the last five years. However, in that time there has been a slight decrease in proportion of overall dry powder accounted for by the mid-market (from 63% in 2021 to 58% in 2024).⁵

Looking more closely at this theme, Figure 2 shows fundraising and dry powder for large-cap private equity funds began growing significantly in 2016. Since then, absolute growth in dry powder expanded by 225% for large-caps compared to just 55% growth in mid-market dry powder over the same period. To put these broader figures more simply, around half of total dry powder in the market today has been raised by large-cap funds, which are chasing less than 10% of the investable opportunities by company count.

² Preqin, as of December 31, 2023. Size classification by deal size (Mid-market: under \$2.5bn; Large-cap: over \$2.5bn).

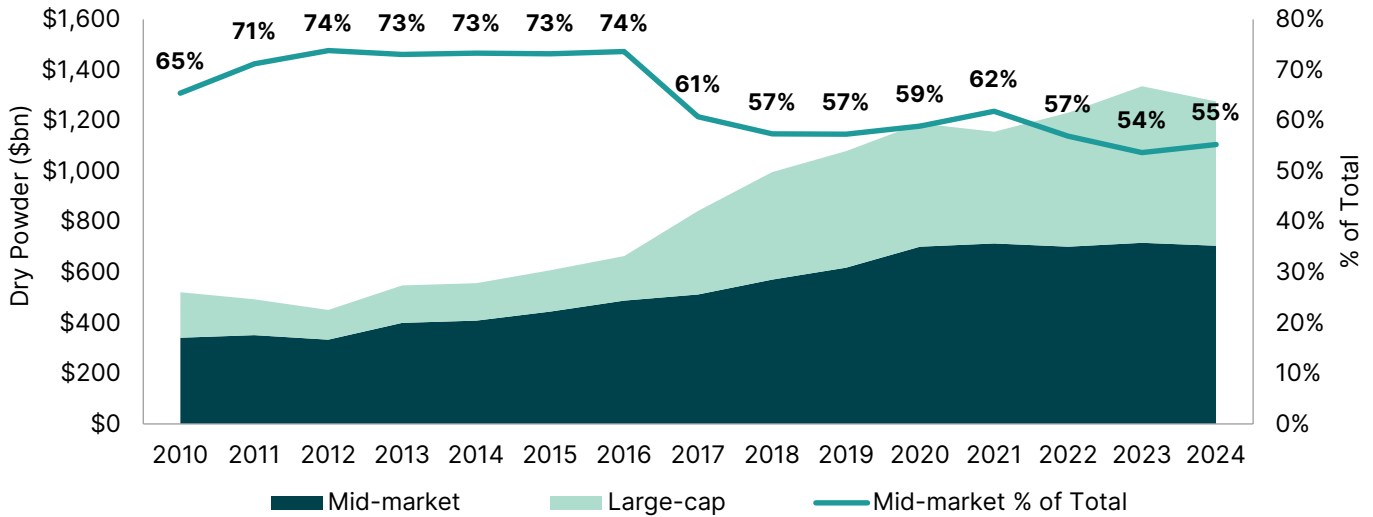
³ Preqin as of December 31, 2023. Size classification by fund size (Mid-market: under \$5B; Large-cap: over \$5bn). Excludes fund of funds and secondaries.

⁴ PitchBook, as of May 2024. Universe includes companies located in the United States or Europe. "Private Markets" refers to companies with PE backing; "Public Markets" refers to listed companies. Size classification by annual revenue (Mid-market: under \$1bn; Large-cap: over \$1bn).

⁵ Preqin, as of May 8, 2024. Size classification by fund size (Mid-market: under \$5bn; Large-cap: over \$5bn). Excludes fund of funds and secondaries to avoid double-counting.



Figure 2: Dry powder split across mid-market and large-cap funds⁶



Mid-market specialization can drive value creation

“Mid-market funds tend to be more specialized, where smaller fund sizes can allow managers to maintain a disciplined focus on niche sectors and industries over time. This specialization enables deeper market knowledge and the potential to identify undervalued opportunities that larger funds might overlook.”

Mid-market funds can differ from large-cap funds in several important ways. Mid-market funds tend to be more specialized, where smaller fund sizes can allow managers to maintain a disciplined focus on niche sectors and industries over time. This specialization can, in turn, enable deeper market knowledge and the potential to identify undervalued opportunities that larger funds might overlook. Conversely, large-cap funds, while typically more diversified, may lack the same level of sector-specific expertise.

Mid-market companies themselves are smaller and are typically earlier in their growth cycle, where there is naturally more space for growth and expansion. For example, mid-market companies are often in the process of expanding their product

and service range, growing geographically from local to regional or from regional to national status, and they often operate in fragmented markets where there can be opportunities to consolidate through mergers and acquisitions (M&A).

Finally, and as alluded to above, mid-market transactions often involve founder- or family-owned sale processes, which require a specific set of skills for recruiting new and more robust management layers post-transaction, alongside implementing institutional processes and systems for the first time. Each of these business-building opportunities in the mid-market poses its own challenges from an execution perspective, but can also lead to a step-change in growth prospects if navigated well.

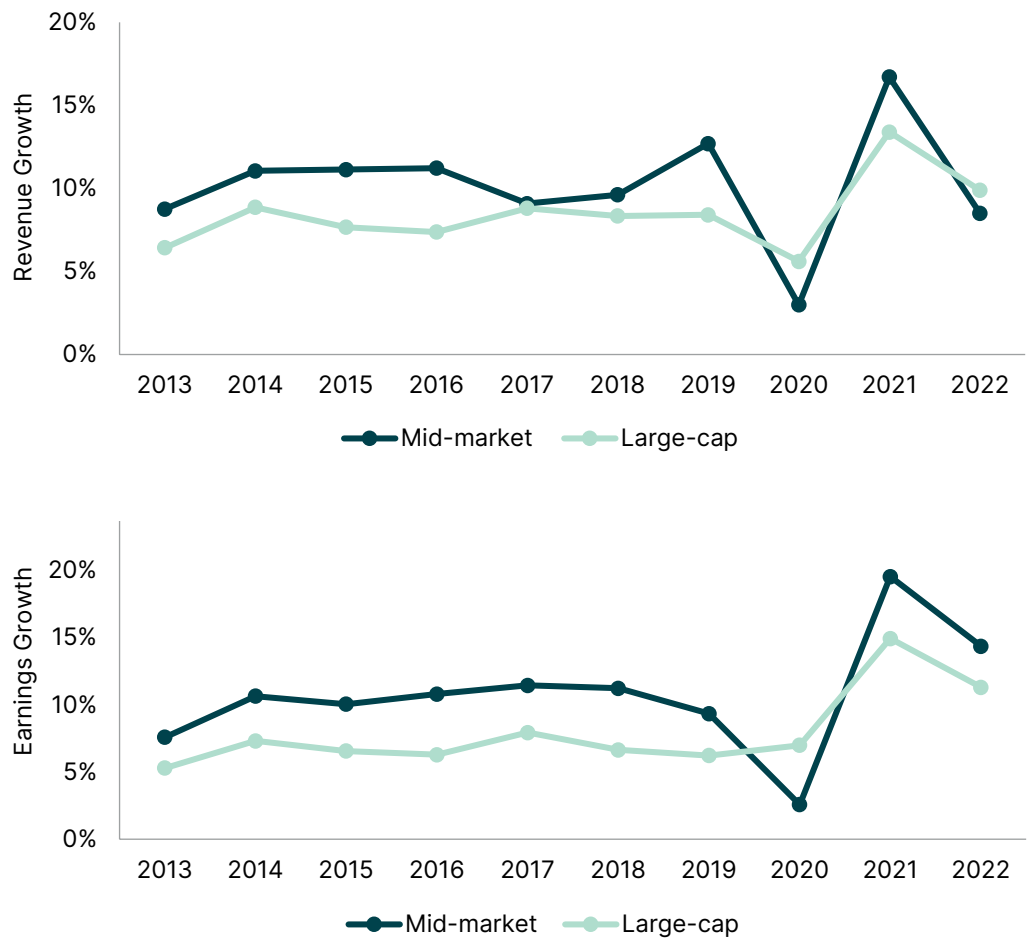
⁶ Preqin, as of May 8, 2024. Size classification by fund size (Mid-market: under \$5bn; Large-cap: over \$5bn). Excludes fund of funds and secondaries to avoid double-counting.



Over the past ten years, mid-market companies have consistently grown faster than their larger counterparts in terms of both revenues and EBITDA (see Figure 3). More specifically, since 2013, mid-market companies have delivered median annual

revenue growth that is ~25% higher than the median annual topline growth rate delivered by large-caps, with median annual EBITDA growth rates in the mid-market ~45% higher than those generated by larger companies over the same period.

Figure 3:
Mid-market companies deliver outsized annual growth in revenue and earnings⁷



⁷ Pantheon deal data, as of March 31, 2024. Companies are classified based on the investment criteria including the strategy and size of the fund. Includes companies invested in from 2000 to 2022.



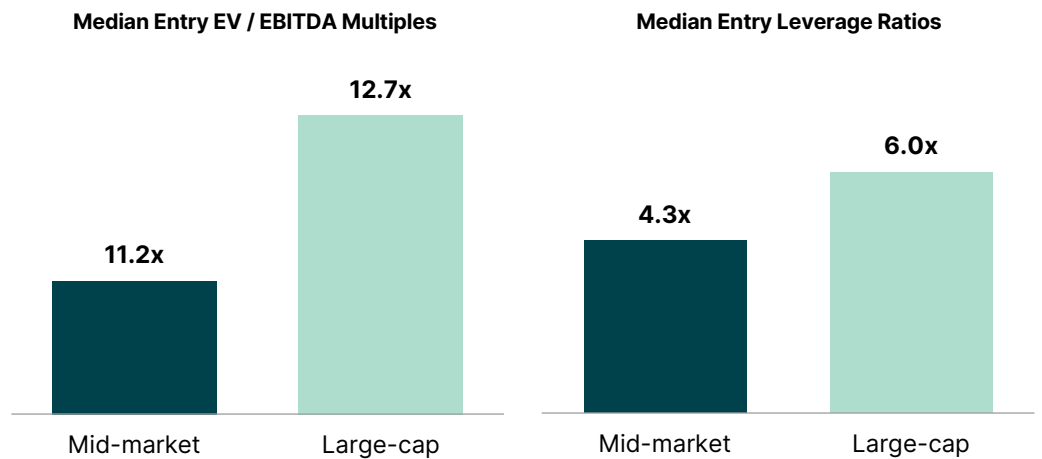
Lower valuations and leverage are hallmarks of mid-market transactions

Notwithstanding their stronger growth profile, over the past ten years mid-market deals have transacted at median pricing that is ~1.5x below that of larger companies – and this has been relatively consistent in each year over the same time frame. Lower valuations in the mid-market have also meant lower levels of leverage have been deployed to get deals done historically, with leverage multiples ~1.7x lower over the same period.

To a large degree, this valuation discrepancy between mid-market and large-cap deals is accounted for by the fact that larger companies tend to be more

polished from an operating perspective; they're more mature and can be less volatile during rough markets. However, although the relative operating stability of larger companies amidst volatile macro periods is favorable in theory, it is important to note that equity values for mid-market funds have still outperformed in prior economic cycles (see Figure 7 on page 11 below). This dynamic is likely a function of the lower leverage levels in the mid-market, which exert less pressure on equity values as valuation multiples and profitability levels compress during periods of downturn.

Figure 4:
Lower entry valuations and leverage are hallmarks of the mid-market⁸



⁸ Pantheon deal data, as of March 31, 2024. Companies are classified based on the investment criteria including the strategy and size of the fund. Includes companies invested in from 2000 to 2022.

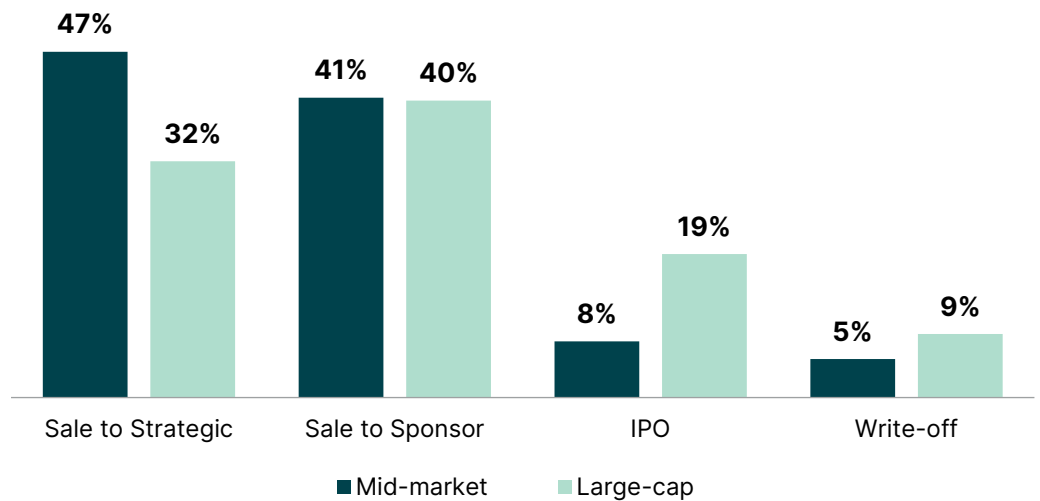


Attractive exit universe for mid-market deals

At exit, mid-market transactions have significant exposure to strategic sales to corporate buyers,⁸ who can underwrite operating synergies and potentially pay higher multiples than other types of bidders. In our research, nearly half of the exits occurring in the mid-market space went to strategic buyers. This stands in contrast to the large-cap end of the spectrum, where less than one-third of the exits in our research were to strategic buyers.

The mid-market is also less reliant on IPOs for exit, with only 8% of total exits occurring via public offerings. This compares with 19% – nearly one-fifth of total exits – that occur by IPO in the large end of the spectrum. Exits to the public markets are typically associated with less certainty around the timing and value of proceeds to investors, and they are also directly dependent on the health of the IPO market itself, which has recently been more muted against a backdrop of wider market volatility.

Figure 5:
Exit pathways by company stage⁹



⁹ Pantheon deal data, as of March 31, 2024. Companies are classified based on the investment criteria including the strategy and size of the fund. Includes companies invested in from 2000 to 2022.



Embedded value in the mid-market is reflected in greater uplift at exit

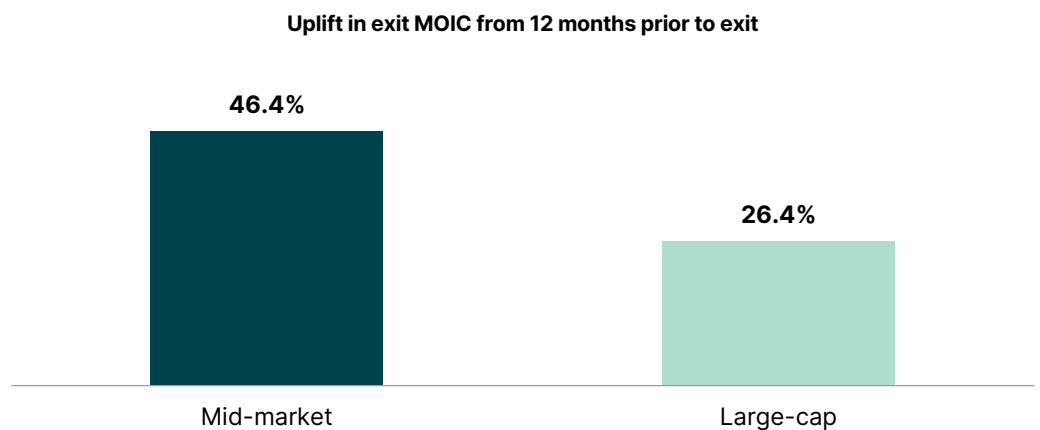
Our research shows that unrealized deals in the mid-market have historically benefitted from higher levels of embedded value, as shown by uplifts to value at exit. Based on data from thousands of fully-realized deals reviewed in our research, and as shown in Figure 6, mid-market companies were on average sold for ~46% more than their holding value a year before exit, vs only ~25% uplift for large companies over the same period.¹⁰

This dynamic where mid-market companies are often not marked up as early or as frequently as large-cap companies likely reflects that larger companies can have a broader range of relevant comparable companies they can be marked against for interim valuations.

Additionally, the initial years of mid-market deals also often involve a significant focus on transformational business-building, as those smaller companies scale and professionalize under private equity ownership, with their ultimate value often not nearly reflected until the final sale.

The notion of embedded value in the mid-market and its potential for a more robust uplift at exit can have important implications for investors in a variety of ways, ranging from how to think about future value growth in portfolios being purchased on the secondary market, to how to evaluate unrealized performance when comparing returns across different sizes or stages within the buyout market.

Figure 6:
Embedded value of mid-market is reflected in greater uplift before exit¹⁰



¹⁰ Pantheon deal data, as of March 31, 2024. Companies are classified based on the investment criteria including the strategy and size of the fund. Includes companies invested in from 2000 to 2022.



Bringing it all together: Potential to drive alpha

Given their potential for higher growth, multiple levers for operational improvements, lower entry pricing and leverage, and more attractive pathways to exit, investing in mid-market assets can offer investors the potential for outsized private equity returns. Since 2006, the top quartile of mid-market funds have delivered a ~24% IRR compared with ~19.5% for the large-cap segment, which equates to ~450bps of outperformance compounded annually over ~20 years.¹¹

In addition to their outsized performance in aggregate, top-quartile mid-market funds have also outperformed large-cap counterparts during every market cycle since 2006 (see Figure 7), highlighting their resiliency through adverse macro periods, including the global financial crisis (GFC). As previously mentioned, better performance through recessions in the mid-market is likely the result of more prudent use of leverage, which places less pressure on equity values and grants mid-market managers more flexibility to navigate recessionary environments without having to frequently negotiate challenged capital structures with lenders at the same time.

Our research has also indicated that, perhaps counterintuitively, smaller companies demonstrate relatively acyclic

hiring patterns, which can position them for solid growth coming out of softer economic periods without having to aggressively rehire. Larger companies, by contrast, tend to over-hire when markets are strong, and they cut headcount much more drastically amidst more volatile periods¹² – a dynamic which was exposed most recently during the highly-publicized mass reductions-in-force that occurred at large-cap tech companies after the 2021 market peak.

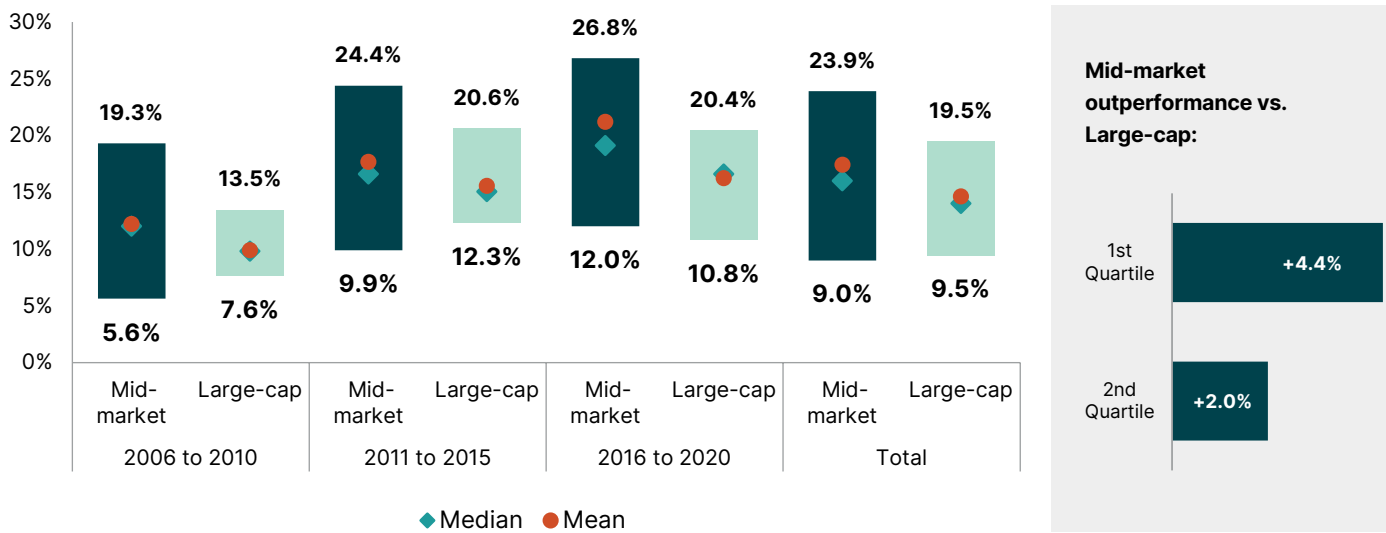
Despite its potential for outsized returns, investing in the mid-market also poses unique challenges; companies are smaller and arguably carry greater execution risk in delivering on their growth potential as they fight for market share with competitor firms, navigate various macro pressures, and diversify their customer bases as they scale. Coupled with the sheer size and breadth of the mid-market and the broad spectrum of value creation strategies and skill levels among GPs, this results in a wider dispersion of returns relative to large-cap funds, as demonstrated by the generally greater interquartile ranges for mid-market funds shown in Figure 7. In contrast to top-quartile funds, since 2006, bottom-quartile mid-market funds returned 9.0% IRR, compared to approximately 9.5% for large end of the market.¹¹

¹¹ Source: Preqin. Fund performance data accessed on July 23, 2024, using the most recent reported data. Includes fund vintages 2006 to 2020. Size classification by fund size (Mid-market: under \$5bn; Large-cap: over \$5bn).

¹² Source: Bureau of Labor Statistics



Figure 7: Funds in the mid-market exhibit strong performance across vintages¹³



“Crucially, in a market that is currently characterized by higher-for-longer interest rates and a tighter financing market – and against the backdrop of a more volatile geopolitical and economic environment – the promise of operational value-add in the mid-market will likely remain appealing.”

The upshot of this reality in the mid-market – where investors must weigh its higher return potential against greater performance dispersion – is that manager selection is of critical importance. The data shows that top-quartile mid-market managers consistently deliver alpha for

investors relative to the rest of the buyout market, so determining a strategy for gaining access to these specialist GPs is something that investors should diligently consider in order to unlock the premium returns that are available.

Keeping the engine running: Outlook

Looking forward to the second half of this year and into 2025, investors are expected to maintain their interest in this segment, driven by its resilience, growth potential, and the strategic opportunities it offers. Crucially, in a market that is currently characterized by higher-for-longer interest rates and tighter financing conditions, and against the backdrop of a more volatile geopolitical and economic environment, the promise of operational value-add in the mid-market will likely remain appealing.

However, as market dynamics evolve, it will remain critical for investors to select

the right managers, investing in the right assets, to realize the performance potential of the mid-market. At Pantheon, we’ve focused on this segment throughout our 40-year history, and it is a high-conviction focus area across our private equity strategies, covering primary fund commitments, direct co-investments, and secondaries. We will continue to bring our expertise and experience to bear to identify opportunities and create value for our investors in this dynamic and evolving space.

¹³ Source: Preqin. Fund performance data accessed on July 23, 2024, using the most recent reported data. Includes fund vintages 2006 to 2020. Size classification by fund size (Mid-market: under \$5bn; Large-cap: over \$5bn).



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