David vs. Goliath

The battle for returns: Lower Mid-Market vs. large-cap

In the timeless story of David versus Goliath, a humble unlikely hero overcomes a towering, formidable opponent, proving that skill, agility, and strategic precision can rival size and strength.

This archetypal story of strategy overpowering size finds a modern parallel in the world of Private Equity, where small transactions - akin to David - stand in contrast to the large-cap giants that dominate the field. While large-cap transactions often boast immense capital and resources, Lower Mid-Market deals bring agility, niche expertise, and often more hands-on operational approaches to drive growth and value.

This rivalry highlights two distinct approaches within Private Equity: the nimble, focused strategies of small & mid-cap deals versus the expansive, resource-rich capabilities of large-cap transactions.

In this paper, we will discuss the potential for outperformance in the Lower Mid-Market segment and explore the related avenues for buyout investors.

Lower Mid-Market funds benefit from favourable fundraising dynamics

The stark imbalance in Private Equity capital allocation highlights the overlooked potential of smaller players. Large-cap funds dominate fundraising, amassing, €6.2 trillion between 2019 and 2024 - a 47% increase compared to the previous five years. Meanwhile, small and mid-cap funds grew by a modest 11% during the same period, raising just €1.8 trillion. Yet, these smaller funds target a vastly larger pool of companies, representing 93% of all global businesses[1].

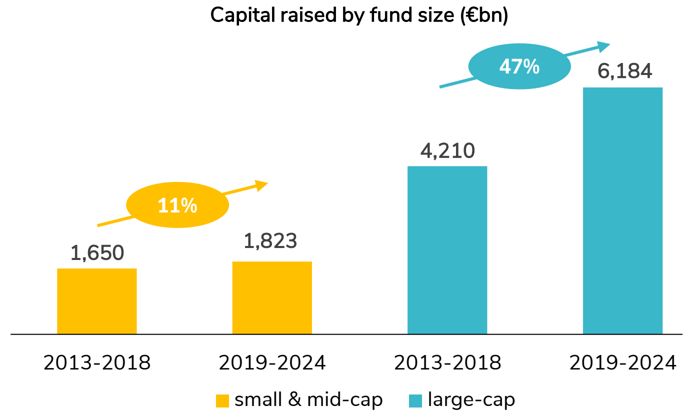


Exhibit 1 - Source: "Q2 2024 Annual Global Private Market Fundraising Report" - PitchBook

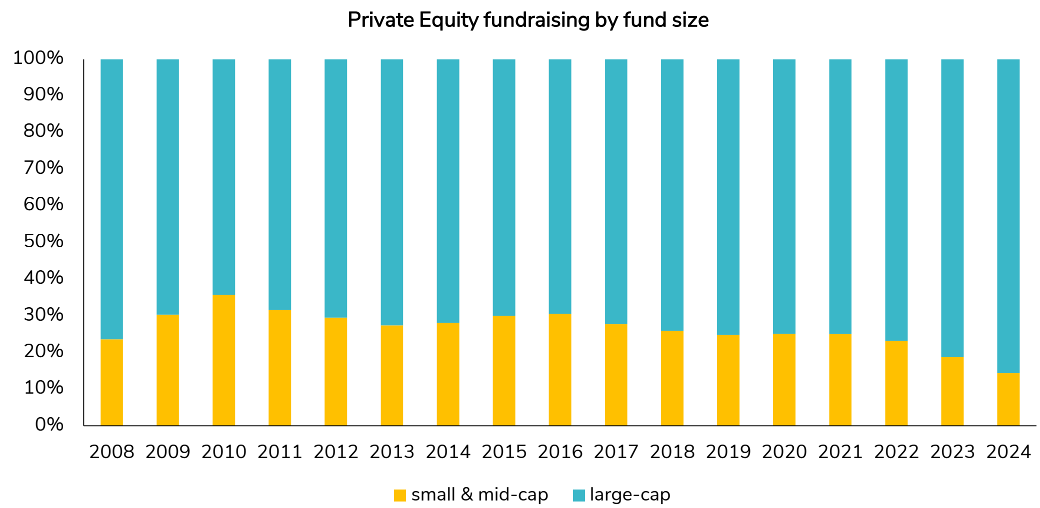


Exhibit 2 - Source: "Q2 2024 Annual Global Private Market Fundraising Report " – PitchBook

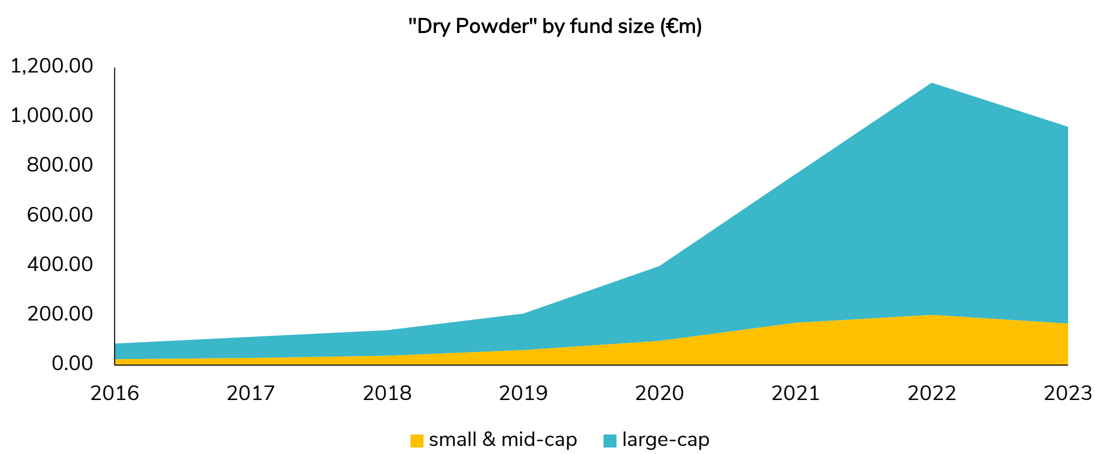


Exhibit 3 - Source: "Q2 2024 Annual Global Private Market Fundraising Report " – PitchBook

[1] *Source: OECD data as of 2023*

In 2024, Lower Mid-Market funds accounted for a record low 14% of the capital raised in the Private Equity market (Exhibit 2), while they are still representing 80% of the total number of funds. This disproportionate capital flow creates two vastly different landscapes. Large-cap funds face fierce competition for a limited number of high-profile deals, inflating entry valuations and compressing future returns (i.e., 86% of the capital is targeting 7% of the companies). In contrast, the Lower Mid-Market targets a wider array of opportunities, with fewer bidders and significantly more attractive entry points. For investors, this creates fertile ground to unlock value where others are not looking.

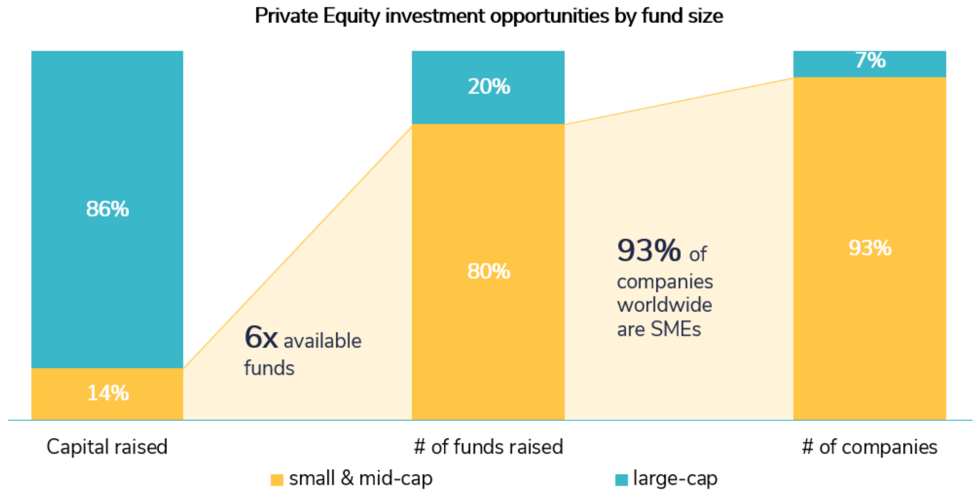


Exhibit 4 - Source: "Q2 2024 Annual Global Private Market Fundraising Report " – PitchBook; OECD data

Entry valuations are more attractive for small & mid-cap deals

Acquiring smaller businesses typically involves better entry valuations (Exhibit 5), reflecting the less competitive market, but also their smaller scale, niche markets, and often concentrated product portfolios. Historically, small and mid-cap companies have been acquired at a 20-25% discount compared to large-cap counterparts.

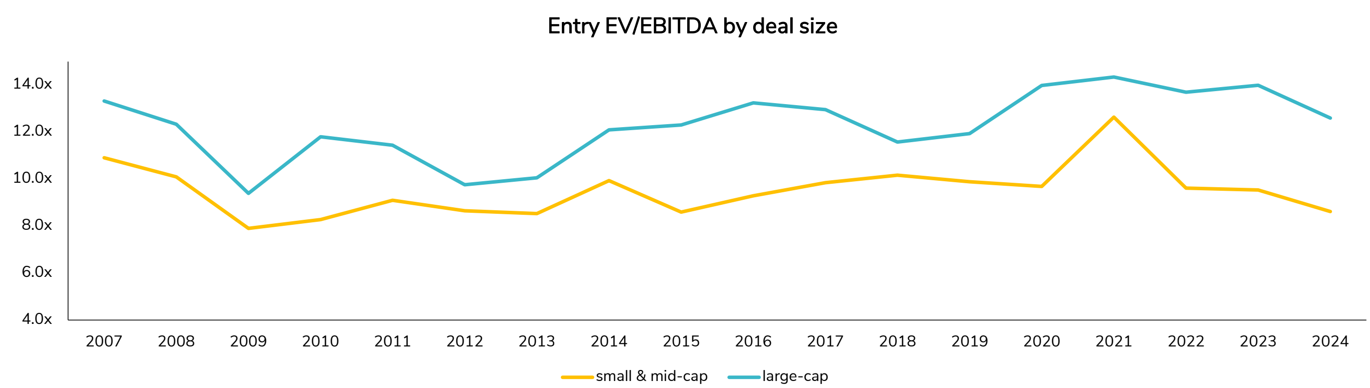


Exhibit 5 - Source: "Q3 2024 Global M&A Report" - PitchBook

Smaller funds create value through strategic and systematic M&A

Over the past 25 years, small & mid-cap funds have consistently been more active in M&A than large-cap funds, executing more than twice as many add-on acquisitions on average (Exhibit 6). This trend can be attributed to the more fragmented nature of the Lower Mid-Market, where a larger number of potential acquisition targets are available. Smaller companies are often in the process of scaling and optimizing their operations, making them more receptive to strategic acquisitions that can accelerate growth or enhance market positioning.

Add-ons are generally acquired at lower entry valuations compared to initial platform investments due to the smaller size. By consolidating smaller targets, buy-and-build strategies achieve a lower blended entry EV/EBITDA multiple for the combined entity. This creates an enhanced potential for multiple expansion upon exit, as the consolidated platform often commands a valuation premium due to its increased scale, operational efficiencies, and strategic market positioning.

The increased buy-and-build activity within the Lower Mid-Market thus presents an opportunity for investors to capitalize on the significant value creation potential from a more dynamic, fragmented market.

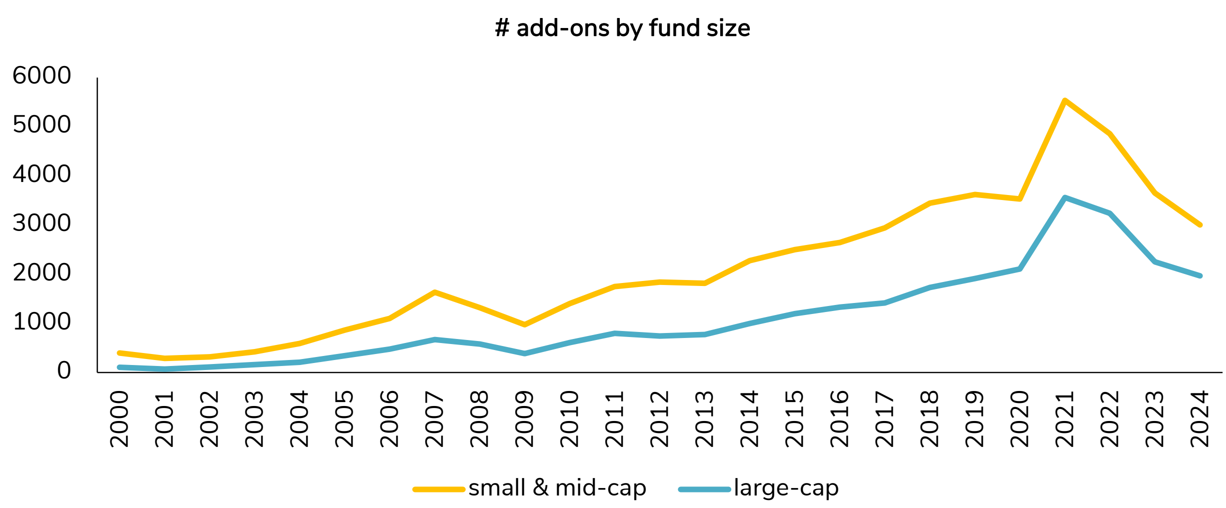


Exhibit 6 - Source: PitchBook, Syz Capital

Lower Mid-Market funds have outperformed large-cap funds

During the last decade, historical data shows that small & mid-cap transactions have outperformed their large-cap peers across multiple economic cycles and vintages[2].

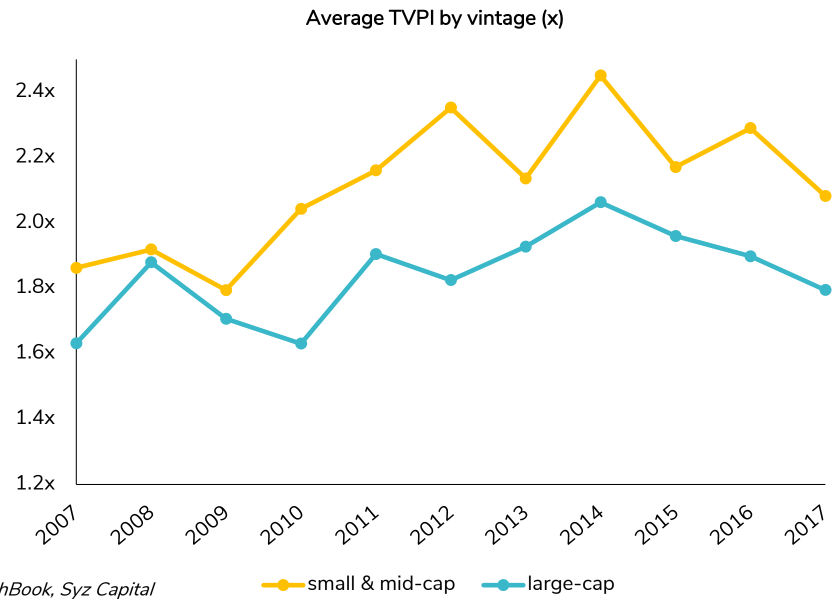


Exhibit 7 - Source: PitchBook, Syz Capital

Although Lower Mid-Market funds offer compelling return potential, they exhibit a different risk profile compared to their larger counterparts. Small & mid-cap funds have broader performance dispersion, with higher top-quartile returns but also lower bottom-quartile outcomes relative to large funds. This variability underscores the importance for investors to conduct thorough due diligence and employ meticulous fund selection strategies when building portfolios in the Lower Mid-Market.

The small & mid-cap segment maintains resilience and liquidity amid market challenges

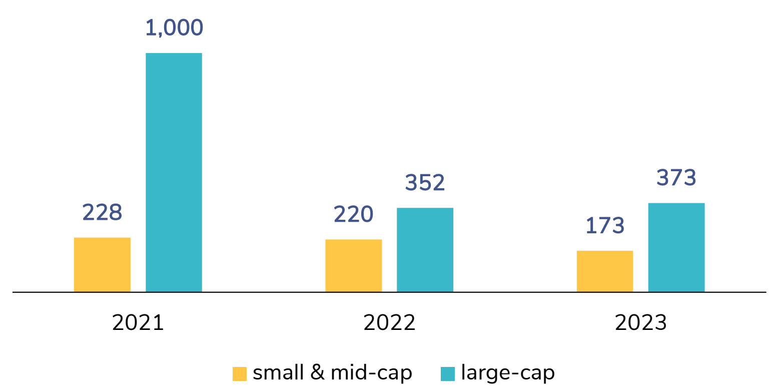
Another key strength of the Lower Mid-Market is its resilience. Small and mid-cap companies, with their lean structures and entrepreneurial leadership, are better equipped to adapt to market disruptions. This adaptability was evident during the challenging years of 2022 and 2023, when large-cap Private Equity exits nearly halved, while the Lower Mid-Market maintained stable activity. These companies focus on specialized markets and flexible operational models which enable them to weather economic turbulence more effectively than their larger, less agile counterparts.

In the US and Europe, the slowdown was entirely driven by the large-cap segment, where exit activity slowed considerably compared to 2021. In contrast, the Lower Mid-Market maintained stable exit activity, further underscoring its enduring strength even

[2] *In our analysis, we have considered c. 10k Private Equity funds (Global) and >140k deals in the buyout, growth and VC space from 2007 to 2017. The classification criteria for fund sizes have been the following: (i) small-cap: fund sizes < €500m; (ii) mid-cap funds: €500m > fund sizes < €1b; (iii) large-cap funds: fund sizes > €1b.*

amidst broader market challenges. According to PitchBook data, value and count of PE exits in 2022, in Europe and the US the value of exits has decreased by 53% vs. 2021 and has not recovered in 2023. However, the exit count has not significantly decreased since 2021. The significant decline in exit value, combined with a relatively stable number of exits, indicates that the slowdown in exit activity is primarily due to a reduced number of large-cap deals. Therefore, the current slowdown in Private Equity distributions is mostly attributable to subdued exit activity in the large-cap segment rather than in the lower end of the market.

Europe & North America - Exit Value (€bn)



Europe & North America - Exit Count

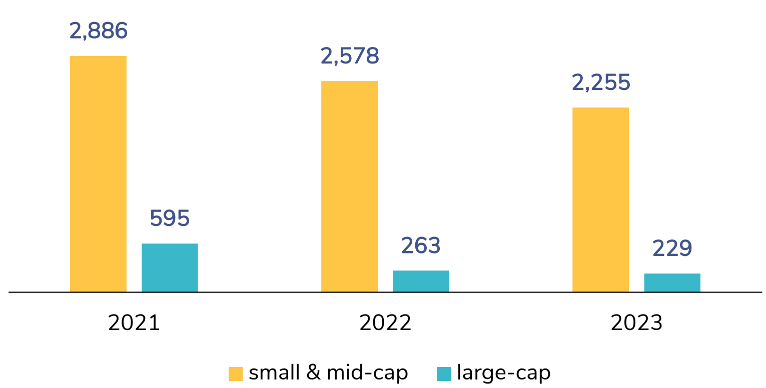


Exhibit 8 - Source: "Q3 2024 US & Europe PE Breakdown" - PitchBook

While large-cap deals are often seen as the gold standard for liquidity, the Lower Mid-Market defies this assumption. Its diverse and ample exit environment - spanning from strategic buyers, well-capitalised larger funds, and public listings - ensures a steady stream of liquidity opportunities. This breadth of options provides investors with both flexibility and stability, even in uncertain markets.

Why the Lower Mid-Market wins

In the increasingly polarised world of Private Equity, the Lower Mid-Market emerges as a compelling David to the Goliath of large-cap funds. While large-cap funds attract significant capital inflows, a limited supply of high-quality deals leads to competitive pressures and elevated entry multiples. Moreover, larger, more mature companies often have limited room for value creation and growth potential.

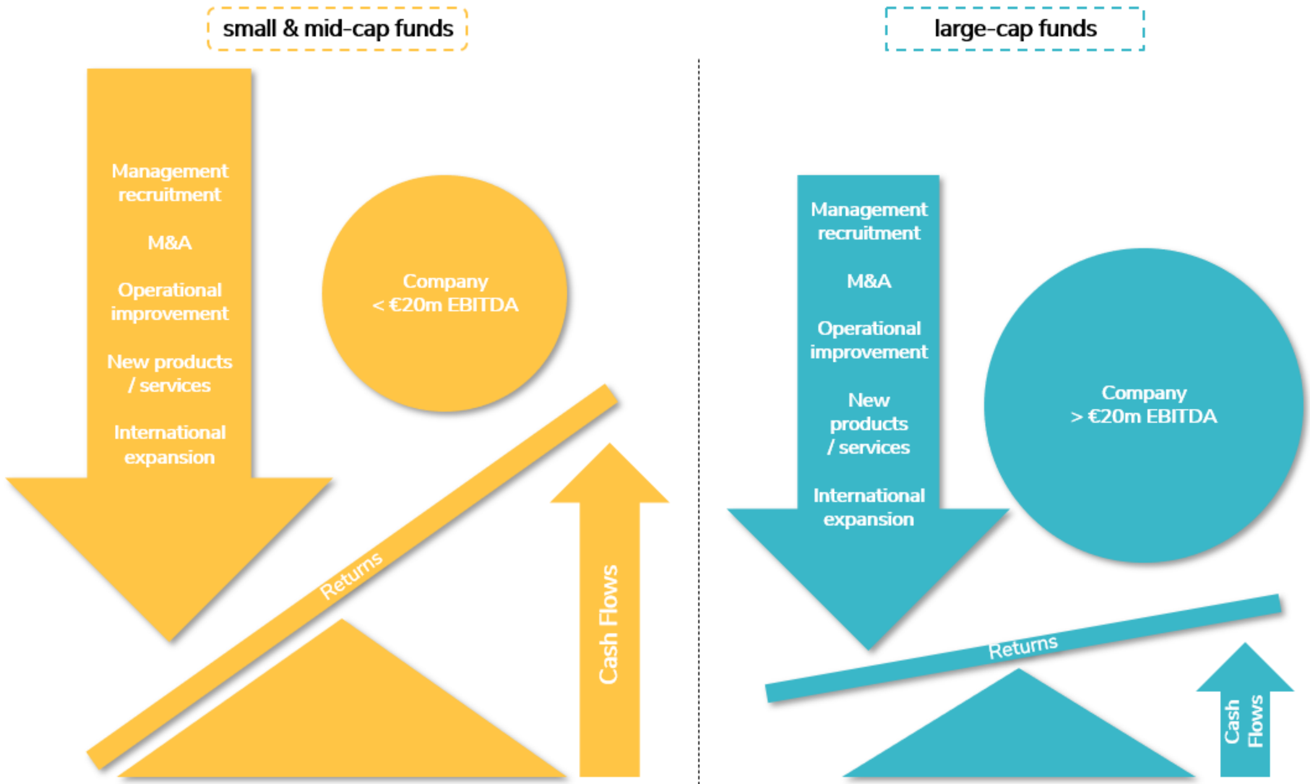


Exhibit 9 - Source: Syz Capital

Conversely, the Lower Mid-Market market offers a broader array of opportunities at more favourable valuations. Syz Capital's analysis highlights how small & mid-cap transactions yield on average superior returns over large-cap deals, driven by structural advantages such as favourable valuations, untapped growth potential, and broader opportunities for value creation. In an era where Private Equity continues to see substantial capital inflows, the Lower Mid-Market presents a compelling landscape for investors seeking high risk-adjusted returns with improved liquidity terms.

In the spirit of David's triumph, the Lower Mid-Market reminds us that strength lies not just in size, but in the ability to act decisively, adapt swiftly, and unlock opportunities where others cannot. For investors seeking dynamic growth, stability amidst volatility, and a forward-thinking approach to investing, the Lower Mid-Market defines the standard for outperformance in Private Equity.

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