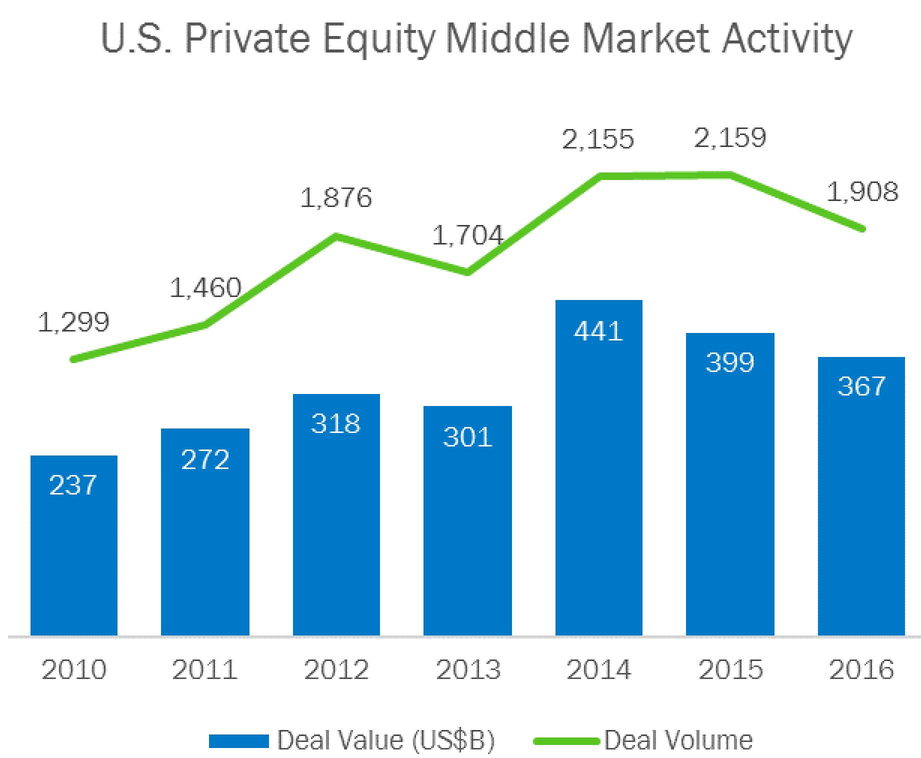
The Lower Middle Market: Resilience in the Face of a Buyout Slowdown

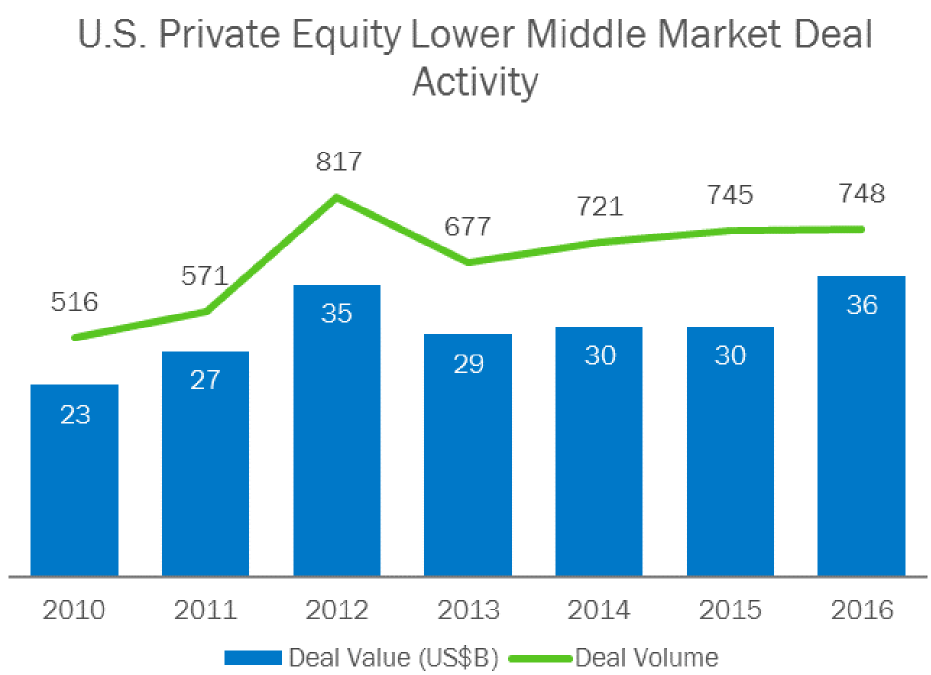
"PE activity in the US middle market thwarted by competition". This is a headline accompanying the release of Pitchbook's U.S. PE Middle Market Report. But while overall middle market deal flow and deal value were down in 2016, it didn't come as a surprise to us that the lower middle market (LMM) bucked this trend.

Middle market private equity (PE) activity registered lower deal value and volume in 2016. There were 1,908 deals closed, with a total value of $355.8 billion, representing decreases, respectively of 11.6% and 8.1% from 2015. This slowdown still places middle market activity ahead of the overall U.S. PE market, where deal value and volume fell, respectively, 12.0% and 14.4% year over year.



As we've noted previously, PE investors are facing daunting competition from strategic buyers. That competitive pressure appears to increase with the size of target, as strategics can justify higher valuations for large acquisitions[1], and are currently supported by lofty stock prices and record amounts of cash on their balance sheets. With these buyers focusing their sights on larger acquisitions in the middle market and beyond, PE investors are directing their attention towards smaller targets that trade at lower multiples, including add-on acquisitions for existing portfolio companies. This is the source of resilience for LMM deal activity.

In 2016, the LMM saw an increase in deal value of 21.3% over 748 transactions (a similar number of transactions to 2015). Compare this to the upper middle market, which saw deal value decline by 20.3% and deal volume by 28.5%.



This pattern of PE deal activity makes sense to us, in an environment where PE's are competing against strategic buyers for a shrinking pool of larger targets. In pursuing smaller (LMM) targets as add-ons to existing platforms, PE owned platform companies will already have infrastructure and management in place, and there is the potential benefit of cost-side and distribution synergies and multiple arbitrage. In addition, there is a clear relationship between valuation and size of target. With valuations reaching lofty new heights, the pursuit of smaller, add-on acquisitions at lower multiples represents an effective path to value creation for PE investors.