



New York | Amsterdam

Investing in US family businesses offers great opportunities for those investors who are willing to build a long-term private equity program¹.

The basic catalysts that support the attractiveness of buying and growing American family businesses lie in the size of this “small cap” segment of the market: it is estimated that in the United States, over 300,000 companies operate with revenues between \$5 and \$250 million per year. Many of these small-cap businesses are private and / or family-owned businesses. Furthermore, another positive attribute of the sector is that it is estimated that \$100 trillion of wealth transfer will occur during the next 20 years as a result of family businesses being sold or inherited².

In addition to the attractiveness of the size of the US family business market, we also believe in the attractiveness of the general growth opportunities for small businesses operating in the US. The uniformity of market components such as language, regulatory issues, media, distribution, and culture within an area including 300 million people is unparalleled anywhere in the developed world. For example, expanding a small, but successful healthcare company from one region of the US into another is much easier in the U.S. than in the European Union.

Beyond the appeal of the market size and uniformity, the family business market has one more important driver of investment opportunity: it is an inefficient segment of the U.S. economy in some critical areas. Buying privately held companies with enterprise values below \$100 million is, and will likely remain for a long time, an opaque business in the United States. Nationally operating investment banks such as Goldman Sachs or JP Morgan simply can not make their minimum fee threshold when attempting to auction off a \$30 million manufacturer of machine parts. In addition, families may not always be interested in selling equity to the buyer offering the highest price. The sales motivation for a family offering its business to investors might include a desire to find a solution to succession issues, a way to diversify assets, or a combination of these and other “non-price” drivers. Therefore, families often work with their trusted attorneys, accountants, or local business brokers to find the financial party who will serve as a true “partner” for the families. Taken together this lack of investment banking intermediation and the search for non-financial solutions often results in lower purchase multiples and attractive

¹ Written by Marc der Kinderen, Managing Partners 747 Capital LLC, for the May 30 & 31 MGI conference in Luxembourg.

² Source: MassMutual / American Family Business Survey & Cornell University.

financing structures such as subordinated seller notes for investors that are interested in addressing these “non-price” drivers.

Despite the many attributes that make the Small-Cap sector appealing to investors, there do remain a number of significant challenges to investing in the area. First, more than 500 professional buyout teams are active in this segment of the private equity market, each of which seeks to highlight what it believes is its own specialization. A team’s stated expertise might be in industry experience, geography, stage of development, or some other area that provides the team with the ability to capitalize on an inefficiency and growth opportunity. To be successful as a buyout fund investor, each of your portfolio funds must be able to consistently:

- Find the most promising smaller companies and acquire them at attractive values;
- Build them up by helping management execute a growth scenario through new initiatives, such as buying competitors or developing new products and markets; and,
- Sell the businesses three to five years later, when the portfolio company is hopefully valued at more than \$100 million –at a higher multiple because the business may now be marketed and auctioned off by a nationally operating investment bank to many potential buyers.

Despite many of the buyout funds’ claims, a majority of the teams operating in the Small-Cap segment do not possess such unique areas of expertise or capability, but rather serve as undifferentiated sources of private capital for small business owners.

For those teams that do possess unique expertise, the Small-Cap sector has been a rewarding segment of the market in which to invest. The process of buying smaller companies, growing and professionalizing them, and ultimately selling them into the efficient middle market has generated a net return to investors of approximately 26% over the last 20 years³. However, the standard deviation in performance between the 500 teams investing in this market place is significant, thus one must be careful to select the right buyout teams.

Many young, experienced investment managers “spin-out” of their former firms to establish new funds. Frequently, the “spin-out” teams and their former fund employers will claim an indential investment track record, which creates an issue of attribution for potential investors in each fund. In addition, another frequent “pitfall” in the space is that successful fund managers often decide to grow their organization and funds under management to increase fee income, rather than staying focused on the size and type of buyouts that made them successful in the first place. Yet another common problem is that some fund managers may decide to change investment strategy over time, which might leave them with deteriorated deal flow or without a network of useful contacts to help their portfolio companies grow.

³ Source: NVCA & Thompson Venture Economics.

Many things change in private equity – and it is very important to review each team raising capital to determine which ones are the most promising ones going forward. Past performance is not always a suitable indicator of future performance. Experience, focus, commitment, a desire to truly build valuable businesses (instead of being a deal junkie), and a hunger to succeed are key drivers of success that change in each buyout team from fund to fund.

In conclusion, to participate successfully in the attractive US family business segment of the private equity market one needs to have an analytical team dedicated to meeting with every buyout group raising capital in the segment, to ensure that each team is consistently benchmarked against each other. It is only through such a dedicated program that we believe an investor will be able to select the most promising buyout groups, as well as avoid participating in those funds that do not have the necessary ingredients required to succeed. As only a small subset of small US buyout teams come to Europe to raise capital each year, it may be advisable to consider investing in a U.S.-based fund-of-funds to obtain access to this attractive asset class. Several US funds-of-funds offer products that include either dedicated “Small-Cap” buyout & growth funds, or alternatively a more diversified portfolio including an allocation to this segment.