

# Finding the Sweet Spot in Private Equity Investing

Bow River Capital Evergreen Fund

## Key highlights

- Middle market companies represent a compelling segment of the private equity market offering opportunities for growth and differentiation.
- Operational improvements in middle market companies can potentially lead to enhanced returns.
- Acquisitions often occur at attractive valuations compared to larger-cap counterparts.
- Sector-specialist private equity sponsors have increased their focus on the middle market.
- Middle market companies benefit from having several exit options with a broader range of potential buyers.



# In the dynamic landscape of private equity investing, discerning investors constantly seek out avenues that offer both stability and growth potential.

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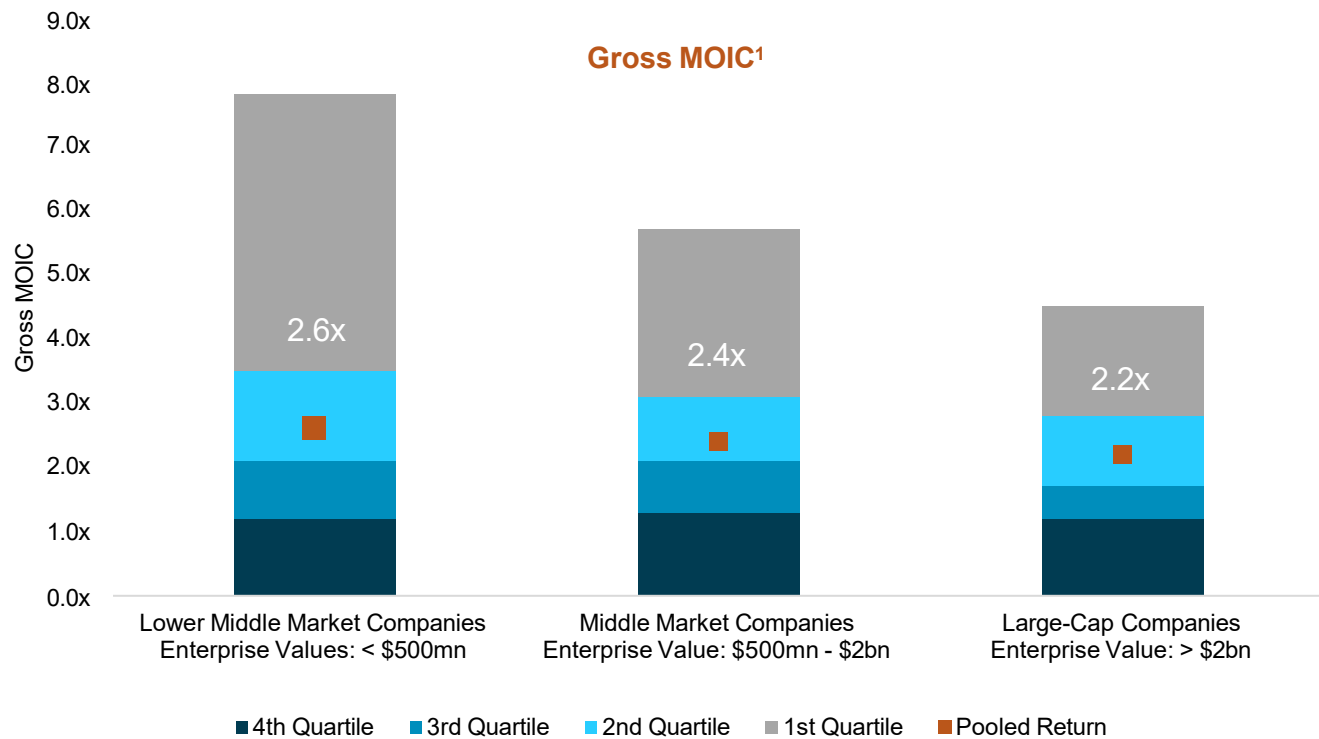
Among the universe of available investment opportunities, middle market private equity emerges as a compelling option. Positioned between smaller start-ups and larger, established enterprises, middle market private equity presents an optimal place to invest for those seeking a balanced approach to risk and reward. Investments within the middle market segment often present a key inflection in the company lifecycle as they possess meaningful growth potential while carrying lower risks compared to start-ups, yet potentially offer higher returns than larger-cap counterparts.

The definition of the middle market can vary among private equity sponsors, but generally, a middle market company is characterized by an enterprise value below \$2 billion, while large-cap companies have valuations exceeding \$2 billion at the time of acquisition. Middle market companies typically generate annual earnings measured by EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) ranging from \$5 million to \$150 million. Additionally, the middle market can be subdivided into the 'lower middle market,' comprising companies with an enterprise value below \$500 million or EBITDA between \$5 million and \$50 million annually.

In recent decades, the private equity sector has experienced substantial growth, presenting investors with extensive investment options. Private equity funds and their sponsors often differentiate themselves based on the size of the private companies they target for acquisition.

While some funds concentrate on large private companies, others prioritize earlier-stage start-ups. However, middle market companies have consistently distinguished themselves among private equity investors by exhibiting outperformance as demonstrated in the chart below.

### Middle Market companies have historically outperformed their large-cap peers



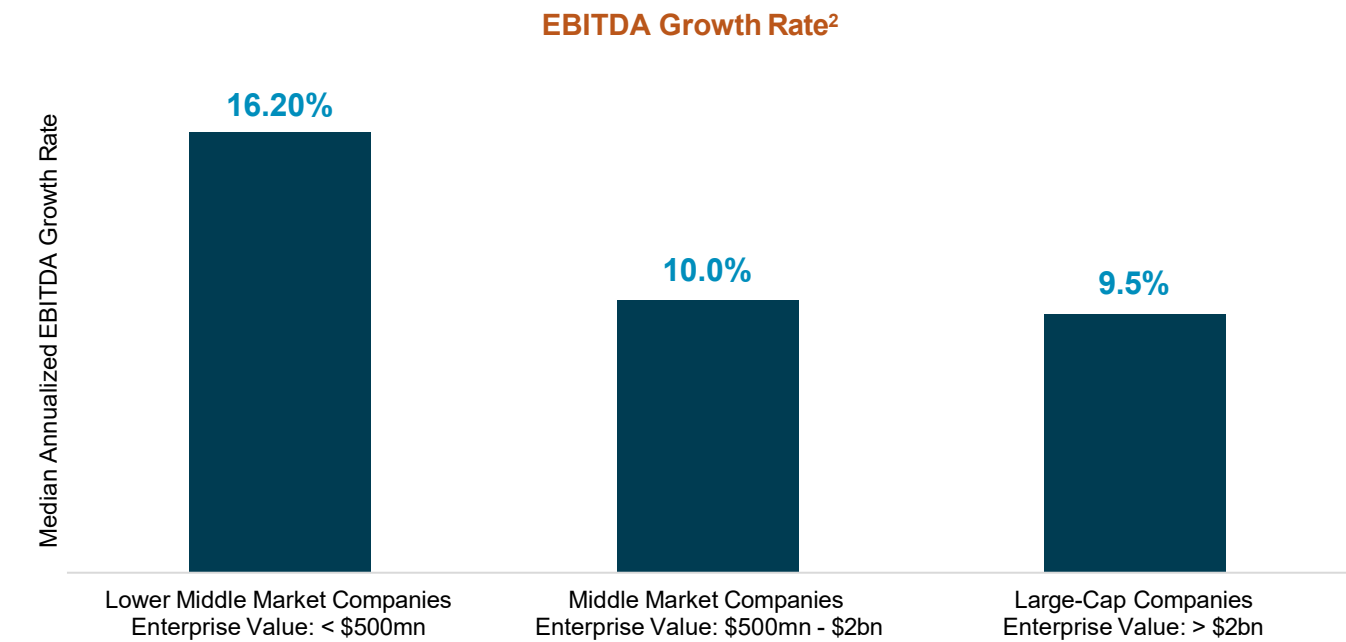
### GROWTH THROUGH OPERATIONAL IMPROVEMENTS

Middle market private companies frequently find themselves at a critical inflection in their business lifecycle. Typically, these companies are well-established and profitable, offering products or services with a proven market and business model. However, often still under family or founder ownership, they stand at a point where infusion of new capital could drive future growth. Through growth capital, these companies can benefit from operational enhancements. This is where private equity investment proves advantageous for middle market sponsors. Private equity sponsors facilitate growth by implementing industry best practices in areas like operations, technology, sales, and human capital management. These hands-on improvements aim to enhance margins and boost EBITDA. As operational efficiencies are realized, employees, managers and investors in middle-market companies stand to benefit.

In contrast, achieving growth through operational improvements is often more challenging for investors in large-cap private companies. The operational enhancements frequently undertaken by private equity sponsors in middle market companies have typically been implemented long ago in larger firms—perhaps when they themselves were in the middle market stage. Reorganizing and improving smaller companies can be executed swiftly and efficiently, whereas implementing significant changes in large-scale private enterprises often demands substantial time and resources.

<sup>1</sup>Aksia Portfolio Company Database, as of September 2023 or latest available. Represents transactions completed between 2011 and 2020 in North American and European buyout funds. MOIC (Multiple on Invested Capital) essentially quantifies how much an investor has made back relative to the original investment.

Middle market companies have historically grown EBITDA at a faster rate than large-cap companies



ACQUISITIONS AT ATTRACTIVE VALUATIONS

Growth achieved through hands-on operational enhancements stands as a pivotal driver of investment returns for investors in private equity middle market companies, yet it is not the sole source. Historically, private equity sponsors have acquired middle market companies at lower valuation multiples—measured by enterprise value to EBITDA multiple— relative to large-cap companies.

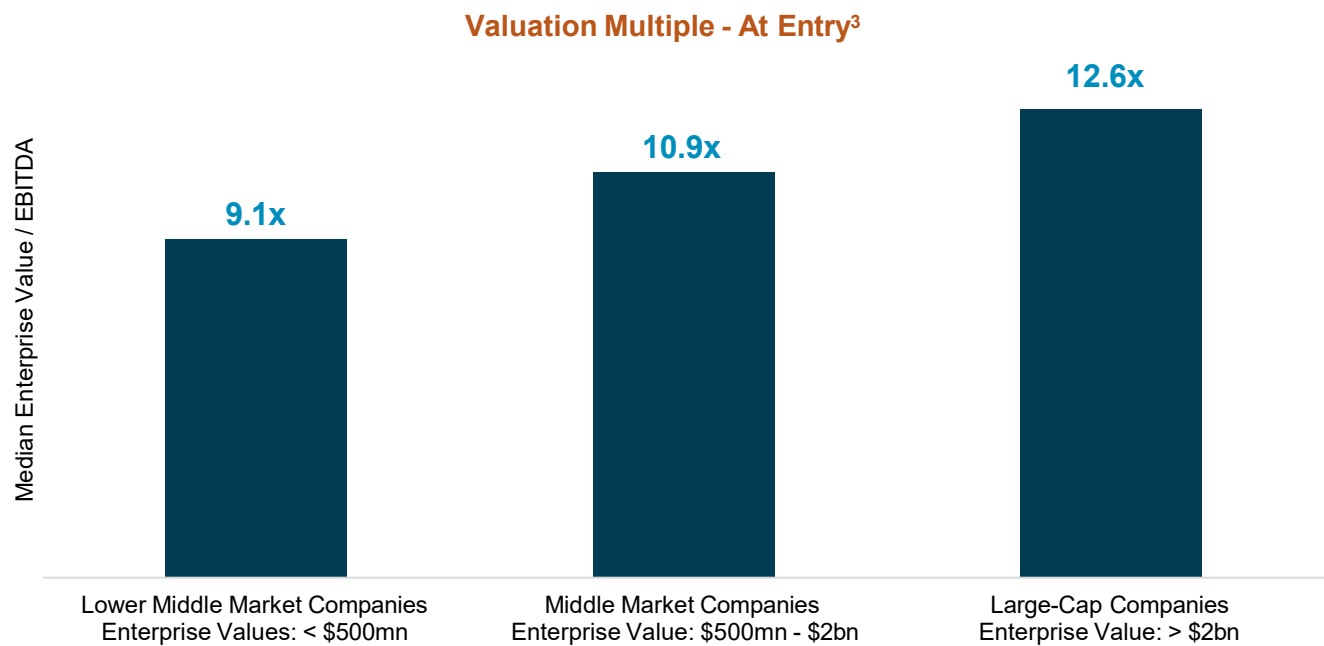
As the private equity industry has evolved, an increasing number of sector-specific private equity sponsors have emerged. These specialists aim to leverage their sector-specific knowledge in partnership with acquired companies to drive operational improvements. Notably, sector-specific private equity sponsors tend to concentrate more on the middle market and consistently yield superior returns in doing so.

Founders frequently prefer to sell majority stakes in their companies to middle market sector specialists while retaining a minority position. Although the financial terms offered by these specialists may not match other offers, founders often choose to collaborate with middle market sector specialists, anticipating the enhancements brought about by these specialists will pave the way for even more lucrative exits in the future. The preference of sellers for middle market sector specialists as partners enables private equity sponsors to acquire these businesses at lower multiples than what might be available to large-cap generalist sponsors.

Valuations for middle market companies can also be lower than those for large private companies due to reduced competition. Private equity sponsors focusing on large companies often have substantial dry powder to deploy. Consequently, they frequently overlook middle market deals as these deals are too small to significantly impact fund level returns. This lack of interest from large-cap sponsors renders middle-market deals less competitive, potentially allowing private equity sponsors to acquire middle-market companies at lower valuations than larger counterparts.

<sup>2</sup>Aksia Portfolio Company Database, as of September 2023 or latest available. Represents transactions completed between 2011 and 2020 in North American and European buyout funds.

Middle market companies have historically been acquired by private equity sponsors at lower valuation multiples than large-cap companies



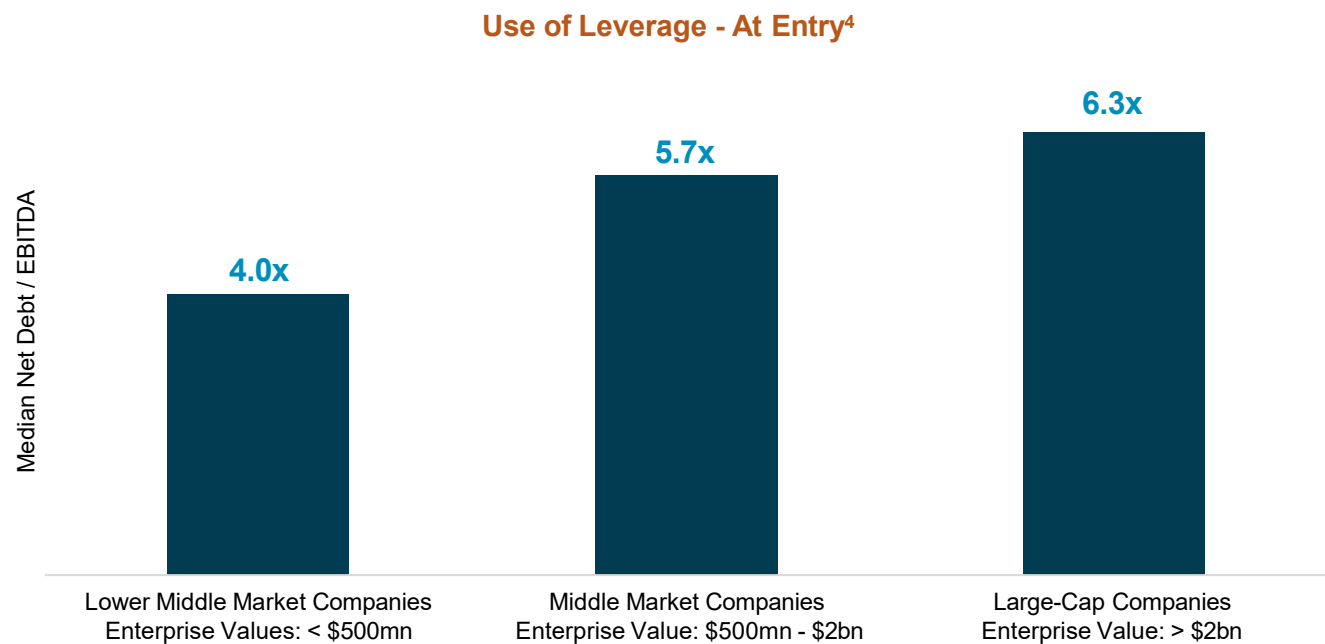
**LEVERAGE ISN'T NECESSARILY AS LARGE A PART OF THE PERFORMANCE EQUATION**

Historically, larger company buyout deals have relied on substantial leverage and financial engineering to bolster investment returns for private equity investors. In a low-interest-rate environment, this strategy can prove successful, albeit more volatile, in generating investment returns. However, in a higher interest rate environment, such as the current one, it becomes increasingly challenging for large-cap company deals to achieve comparable returns using leverage.

Conversely, middle market deals have not traditionally been characterized by the prevalence of high levels of borrowing to finance acquisitions. The smaller scale of middle market deals allows for financing with relatively modest levels of debt. Moreover, because middle market deals do not rely on debt financing to the same degree as larger company deals, they are less susceptible to fluctuations in interest rates.

<sup>3</sup>Aksia Portfolio Company Database, as of September 2023 or latest available. Represents transactions completed between 2011 and 2020 in North American and European buyout funds. Valuation multiples are financial measurement tools that evaluate one financial metric as a ratio of another, in order to make different companies more comparable. Multiples are the proportion of one financial metric to another financial metric.

Middle market companies have historically used less leverage when acquired by private equity sponsors than their large-cap peers



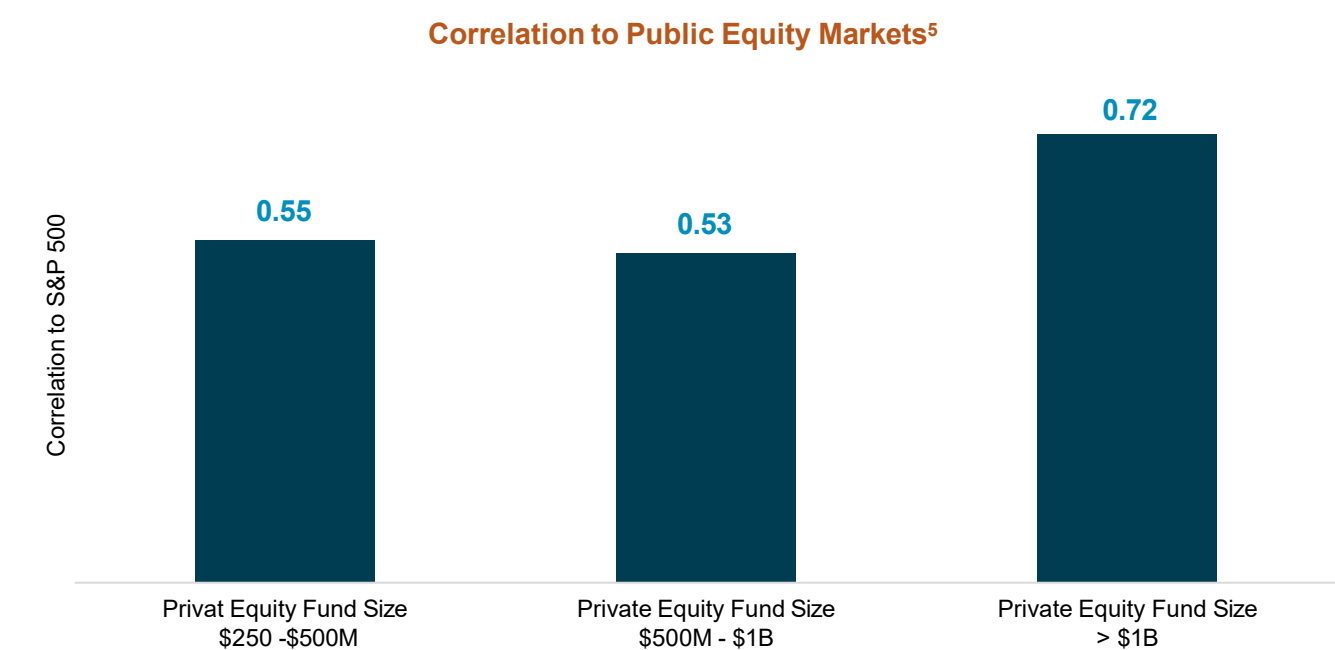
**VOLATILITY IMPROVEMENTS THROUGH DIVERSIFICATION AND LOWER CORRELATION**

Due to their smaller scale, middle market businesses often offer a narrower range of products and may operate within niche, but rapidly expanding industries or regions compared to larger private companies. While each of these aspects may entail individual risks, when aggregated within a diversified middle market private equity portfolio, much of the idiosyncratic business risk can be mitigated while retaining the opportunity for private equity sponsors to implement operational enhancements across the portfolio.

The smaller size of middle market companies typically results in company valuations being primarily influenced by underlying company fundamentals rather than broader macroeconomic factors. Consequently, this can diminish correlation to public market equity benchmarks, thereby enhancing the risk reduction benefits of including middle market private equity within a broader, well-diversified investment portfolio. In contrast, larger companies, even private ones, often exhibit greater sensitivity to the overall economy and consequently tend to display higher correlations with public market equities.

<sup>4</sup>Aksia Portfolio Company Database, as of September 2023 or latest available. Represents transactions completed between 2011 and 2020 in North American and European buyout funds. Leverage refers to using debt (borrowed funds) to amplify returns from an investment or project.

Middle market companies have historically exhibited lower correlation to public market equities than large-cap private companies



**MULTIPLE EXIT OPTIONS**

Private equity buyout sponsors are inherently focused on identifying exit options for the companies they acquire. The exit strategy serves as the means for returning capital to investors and realizing returns on investments. Middle market companies typically enjoy a broader array of exit options compared to larger companies.

Due to their scale, private equity sponsors of large-cap companies often orient their exits toward the IPO market. Realistically, given the size of these companies at the anticipated exit, options beyond a public listing are limited. However, Initial Public Offering (IPO) markets can be volatile, and the ability to sell a private company at an attractive price via public offering is heavily reliant on a robust macroeconomic environment, which may be transient.

Conversely, middle market private equity sponsors have a more diverse range of exit avenues owing to the smaller size of their portfolio companies. While an IPO remains a viable option, sponsors often find willing purchasers offering attractive valuations from various interested parties. These purchasers may include other private equity sponsors as well as strategic buyers.

<sup>5</sup>Source: Pitchbook. Correlation based on quarterly performance of Pitchbook private equity fund benchmark performance compared to quarterly S&P 500 Index performance from January 1, 2001 to June 30, 2023. Correlation is a statistic that measures the degree to which two securities move in relation to each other.

# Conclusion

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While large-cap private equity does have merits as part of a diversified portfolio, the middle market arguably represents the most appealing segment within the private equity market. The size of companies within this segment inherently offers structural advantages that are not easily replicated by private equity managers focused on large-caps. Through more favorable entry valuations, moderated debt levels, enhanced growth, idiosyncratic exposure, and more exit options, middle market private equity can both provide strong return potential and risk mitigation as part of a key allocation within a private equity program.

## RISK DISCLOSURES

An offer can only be made by the prospectus and only in jurisdictions in which such an offer would be lawful. The prospectus contains important information concerning risk factors and other material aspects of the Fund to carefully consider and must be read carefully before a decision to invest is made. An investor should consider the fund's investment objectives, risks, charges and expenses before investing. This and other important information can be found in the fund's prospectus. Please visit [www.bowriverevergreen.com](http://www.bowriverevergreen.com) or contact your Financial Advisor to obtain a copy of the prospectus.

*Any person subscribing for an investment must be able to bear the risks involved and must meet the suitability requirements of the Fund. Investors could lose all or a substantial amount of their investment. No assurance can be given that the Fund's investment objectives will be achieved. The Fund is speculative and involves a substantial degree of risk. The Fund is a closed-end, non-diversified management investment company that will make periodic repurchase offers for its securities and is highly illiquid. There is no secondary market for investors' interests, and none is expected to develop. There are certain restrictions on transferring interests. Fees and expenses will offset the Fund's trading profits. The Fund is subject to conflicts of interest. Other risks include those related to equity securities, fixed income securities, high-yield/high risk bonds, listed private equity, listed infrastructure securities, foreign securities, derivative instruments, leverage, capital calls, investment manager risk, as well as those related to general economic and market conditions, all of which may present significant risks. Please see the prospectus for more information on these and other risks.*

*The Fund and its investments may employ leverage through borrowings or derivative instruments and may directly or indirectly acquire interests in companies with highly leveraged capital structures. Any event that adversely affects the value of a Fund Investment will be magnified to the extent leverage is employed and could result in substantial losses, exceeding those that would have been incurred if leverage had not been employed. There are inherent risks in investing in private equity companies, which are vehicles whose principal business is to invest in and lend capital to privately-held companies. Generally, little public information exists for private and thinly traded companies, and there is a risk that private equity investors, like the Fund, may not be able to make a fully informed investment decision. Typically, private credit investments are in restricted securities that are not traded in public markets and subject to substantial holding periods, so the Fund may not be able to resell some of its holdings for extended periods, which may be several years. Further, investments in private securities are illiquid, can be subject to various restrictions on resale, and there can be no assurance that the Fund will be able to realize the value of such investments in a timely manner. See Private Credit Risk. Further, semi-liquid investments do not offer investors full liquidity (i.e. such investments typically only offer monthly or quarterly liquidity).*

Bow River Asset Management LLC d/b/a Bow River Capital ("Bow River Capital") is the management company for the Bow River Funds.

All statements made herein are opinions of Bow River Capital and should not be construed as investment advice and recommendations. Fund holdings and allocations are subject to change. Diversification does not assure a profit nor protect against loss in a declining market.

**The data shown in the charts throughout this paper refer to characteristics of a universe of middle-market and large-cap companies and do not represent or predict the performance of the Fund. Past performance is no guarantee of future results.**

Fund Distributor: Foreside Financial Services, LLC