How much potential is in the middle market? Quite a bit

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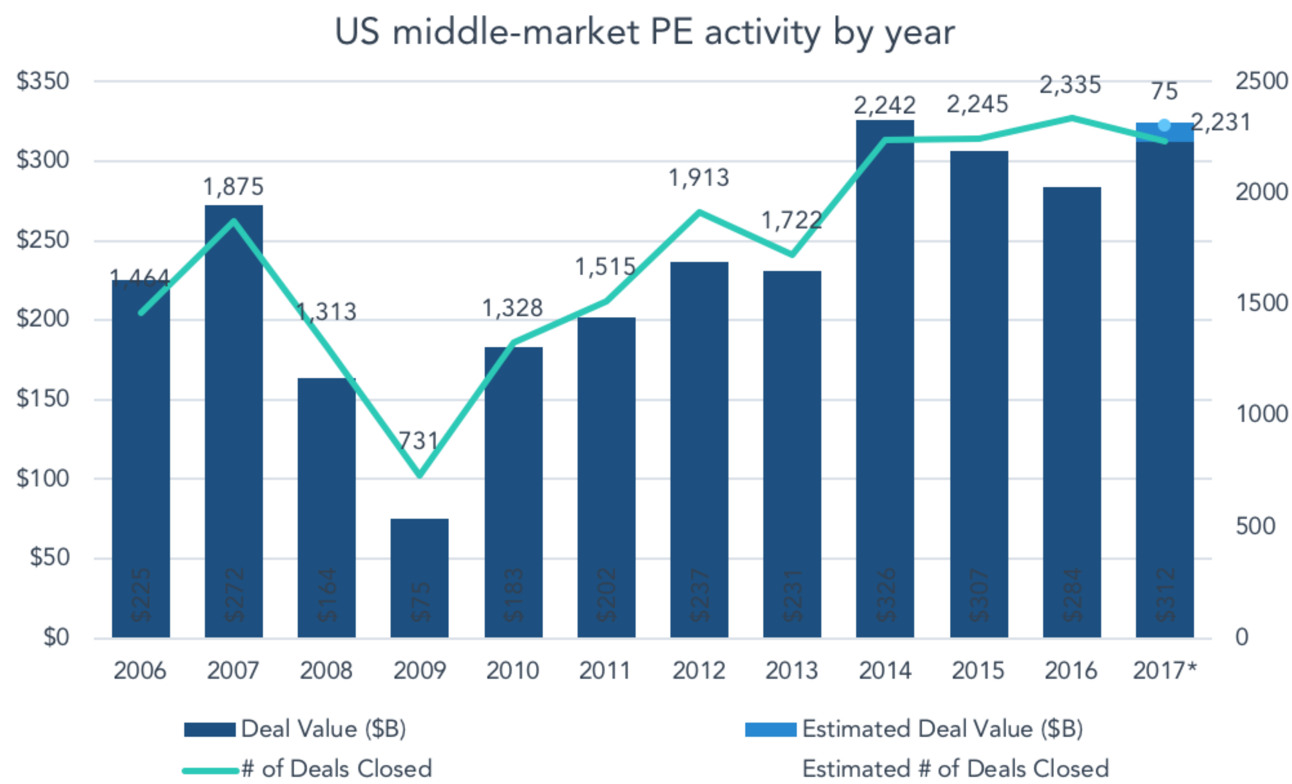

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The middle market continues to outpace the broader private equity market. According to PitchBook's 2017 Annual US PE Middle Market Report, deal volume in the $100M-$1B range last year was about even with 2016 totals, and overall value was up a notable 9%. The broader PE market, however, took a slight dive last year, declining 9% in volume and 12% in value against 2016 totals. Both trends make sense, in that the PE players have, anecdotally at least, expected deal volume to decline a bit in today's overpriced environment. The middle market, meanwhile, remains a hot destination. Investors who insist there are opportunities in the MM seem to mean it—the numbers buttress the anecdotes.

But lower valuations aren't the only reason for PE's massive shift. The middle market is growing on two fronts; the number of companies in that size range continue to increase in number, as do the number of investors targeting the middle market. An estimate from late 2017 hinted that 350,000 companies reside in the $5M-$100M revenue range, and another 25,000 companies bring in revenues between $100M-$500M. That comes out to a little less than 400,000 targets available, and MM deal volume has ranged in the low 2,000s per year since 2014. As a raw percentage, that's a market penetration of half a percent. Realistically, niche investors can expect far fewer targets in specialized sectors, but the number of targets are still far higher at the lower end of any market. The typical niche sector probably has around 10 to 20 targets to consider in the $1 billion+ range. The same space may have several hundred more in the sub-$1B category. Almost by definition, those smaller companies tend to offer more opportunity for operational enhancements versus the billion-dollar targets, as investors are well aware.

Greeting the growing number of companies is a growing number of MM investors. It’s not an accident that the number of new sub-$1B funds has grown over the last five years, and much of that growth is due to the issue of succession and turnover. Many first-time MM managers cut their teeth at bigger buyout shops, and when first-times decide to strike out on their own, they tend to target their own sector specialties but at the lower end of the market. That’s a much more compelling strategy to present to LPs, who sometimes conflate fund size with superior experience. The middle market is the beneficiary, gaining experienced investors willing to roll up their sleeves away from the spotlight.

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