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Why Private Equity Matters (Part Four)

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There are many faces of a leveraged buyout dollar. The private equity industry offers a robust landscape of strategies that provide a wide spectrum of risk-return profiles appealing to different investor requirements. Whether equity or credit-oriented, there are many options for investors to construct portfolios to meet their specific risk-and-return goals.

As we covered in the first installment of our special series, in a typical LBO the sponsor puts up the equity and borrows money from a lender to complete the purchase of a company. The total price – debt plus equity – paid for the company is its enterprise value (EV). Investors can access that equity through a variety of flavors. First, let's look at size of the borrower.

Upper middle market (UMM) buyouts involve EVs of $1 billion to $5 billion, often featuring well-known companies that attract attention from large institutional investors and involve highly competitive processes to acquire. Middle market (MM) LBOs range from roughly $250 million to $1 billion. These businesses are large enough to support professionalized management teams and have proven business models, but the market is less efficient than UMM.

Lower middle market (LMM) LBOs are companies of less than $250 million of EV. Because of their limited scale to start, these businesses have more potential for value creation, but harvesting the "low hanging fruit" of these investments carries higher execution risk. Targeted equity returns for investors are around 20%, somewhat higher for LMM, and lower for UMM.

When a sponsor borrows money to buy a business, those debt securities are also accessible to investors who seek current income and a more conservative risk/return profile. Referred to generally as private credit, these financings represent $1.5 trillion asset class spanning the entire capital structure, from senior secured lending to subordinated debt.

Direct lending is a category within private credit providing senior secured loans to support private equity transactions. It yields 8-9% over time, with low loss rates and has attracted many sophisticated institutional investors seeking diversity from traditional fixed income. Managers can employ fund-level leverage, which can enhance returns.

Junior capital sits lower in the capital stack and includes higher floating rate second lien loans or fixed coupon mezzanine debt that sits in between senior debt and equity. These generate 11-13% yields with a premium to senior debt but lower risk than equity. Some strategies offer non-cash, PIK (payment-in-kind) notes at the holding company level at higher yields.

In today's market private equity is a spectrum of securities, each offering a distinct blend of risk and return. Understanding where each security sits in the capital structure – and what risks drive returns – allows investors to construct portfolios that reflect their own objectives. The opportunity is not choosing private equity broadly but having the right exposure within it.