Private Equity Partners | market update

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Growing Demand for Lower Middle-market Buyout Funds

We have recently seen an up-tick in demand for lower middle-market buyout ("LMMB") funds from institutional investors. This increased interest is in part a reaction to the large amount of capital that has flowed into the large and middle-market buyout sectors in recent years, making those sectors increasingly efficient and competitive (although there are mitigating factors that we have described in previous commentaries). We thought it might be interesting to discuss a few characteristics in the LMMB sector that we believe makes it an attractive place to be investing today.

First, there are approximately 140,000 companies in the U.S. with revenues between $10 and $100 million, compared to only about 30,000 companies with revenues of greater than $100 million. So purely from a numerical standpoint there are more potential LMMB investment opportunities. Second, there is often less competition in the LMMB sector and LMMB funds have better chances to source deals on a proprietary basis rather than to buy them at competitive auctions. The smallest funds ($0-$250 million) had the smallest year-over-year percentage increase of capital in-flows from 2003-2004, and fundraising levels for such firms in 2004 were at 1993-1994 levels. Third, there are substantial growth and cost-saving opportunities in small companies—almost by definition because smaller companies tend not to have the economies of scale that permit labor, distribution and inventory cost reductions or the latest technology enhancements. Further, LMMB funds can often create value by improving the quality of the management team at small companies, as many small companies may not be able to attract strong management teams due to compensation limits or because they are closely-held corporations. Finally, valuation multiples tend to be higher for bigger companies, which means LMMB funds have the ability to buy a company for 5-6x EBITDA and through organic growth or acquisitions, build a larger organization that can then be sold for a higher multiple such as 9x EBITDA. Of course, an investment in a small company may bring an added set of risks—the company may be dependent on a small concentration of customers, have a less sophisticated operating platform or weaker financial controls, among other factors.

Fund Manager Selection

Across the buyout spectrum, manager selection is critical. When we are seeking LMMB managers, we focus on the following key attributes:

- A strong and consistent performance record.
- Operating, management, consulting and finance experience that enable a portfolio company team to accelerate growth, improve operational efficiencies and reduce costs.
- An ability to truly generate proprietary deal flow through extensive industry contacts, deep industry expertise or a unique investment strategy (e.g., buying ignored divisions of large healthcare companies and pairing them with other assets to create a single, strong entity).
- A highly motivated, cohesive team that has worked together for many years.
- Investors who maintain pricing discipline (i.e., do not overpay) and who consistently execute their stated investment strategy.
- Alignment of financial interests with ours (i.e., the carried interest fee, rather than the annual management fee, is their primary motivation).
- Conservative valuation methodology for portfolio companies.
- Superior execution abilities and knowledge of the capital markets—knowing how and when to exit an investment are as important as knowing when to invest in the first place.

We hope you find this information valuable and welcome your questions and comments.

*Piper Jaffray was established in 1895 and has grown to become a nationally and internationally recognized firm serving growth companies and growth company investors. We have a significant commitment to alternative assets through our series of fund of funds, **Private Equity Partners**, and anticipate offering our next fund, **Private Equity Partners III,** in early 2006.*

Private Equity Partners

Scott Barrington
612 303-1110
scott.l.barrington@pjc.com

Dan Donoghue
312 920-2132
daniel.j.donoghue@pjc.com

Private Capital Group

800 Nicollet Mall
MS: J09N03
Minneapolis, MN 55402

Hyatt Center, 24th Floor
71 South Wacker Drive
Chicago, IL 60606-4616

Find us on the web at
piperjaffray.com/fundoffunds