FOR PROFESSIONAL INVESTORS AND FINANCIAL ADVISERS ONLY – NOT FOR USE BY RETAIL INVESTORS

Global lower middle market private equity:

Navigating a complex environment in search of outperformance

2017

Kuala Lumpur, Malaysia

Aberdeen

Contents

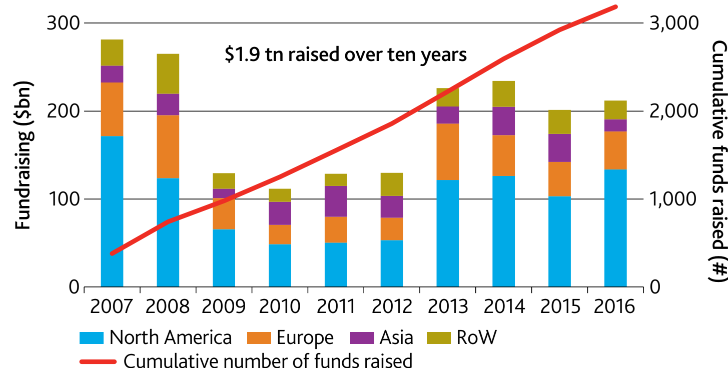
Introduction	03
The search for outperformance	05
The global lower middle market landscape	06
Unlocking value in the lower middle market	08
Considerations for accessing the global lower middle market	09
Summary	11

FOR PROFESSIONAL INVESTORS AND FINANCIAL ADVISERS ONLY – NOT FOR USE BY RETAIL INVESTORS

The global private equity (PE) market has grown in astounding ways since the turn of the century. Over the past decade, $1.9 trillion has been raised globally across more than 3,000 distinct funds, as shown in Figure 1. PE firms that once executed on rather straightforward and easy-to-understand business models have in many cases grown into multi-billion dollar asset management behemoths pursuing a range of private capital strategies.

Today, one need look no further than the public markets (ironically) to find some of the most well-known global PE firms in the industry, including Blackstone, Carlyle and KKR. In the U.S., firms that were built on the back of a middle market generalist model of buying small companies across a range of industries are increasingly focused on more specialized investment strategies and complex financial engineering to generate returns from much larger deals. Similarly, in Europe, many of the largest players in PE – such as CVC and Bridgepoint – are now a far cry from their traditional roots as the PE arms of large banks. And in Asia, a region undergoing dramatic growth, large pan-regional powerhouses are juxtaposed alongside a remarkably diverse collection of local venture, growth and PE firms.

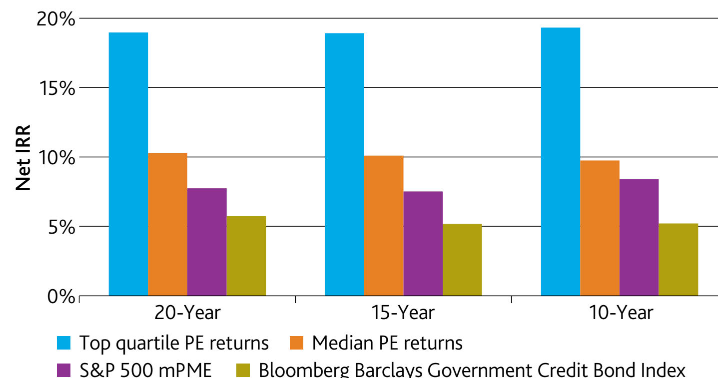
Figure 1: Global PE fundraising



Source: Preqin, January 1, 2007 - December 31, 2016. Fund types: Buyout, growth and turnaround funds. For illustrative purposes only.

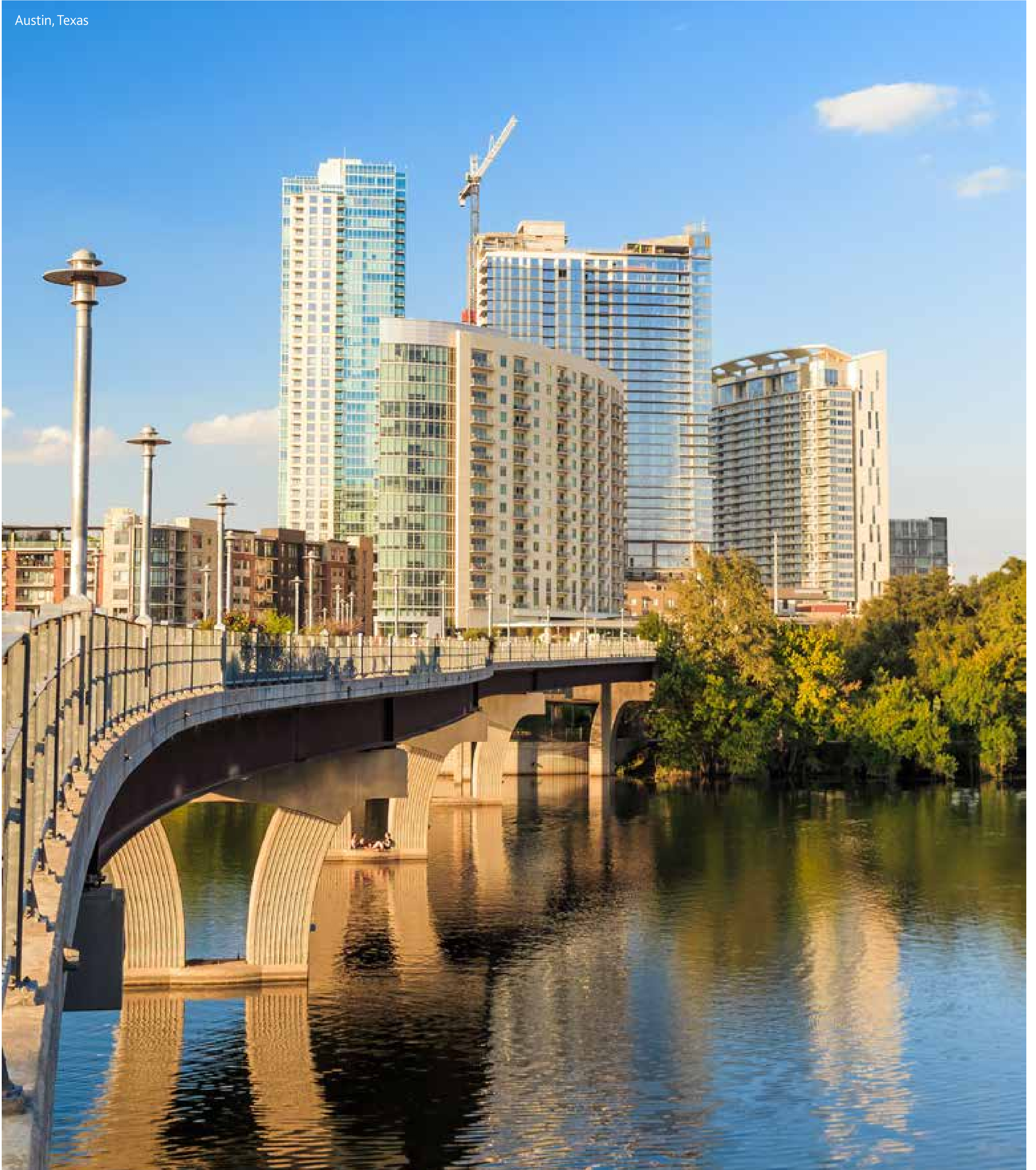
What has driven the immense growth of the global PE market? The answer is rather simple: returns. Across nearly all long-term time horizons, private equity has outperformed the public markets and generated strong returns on both an absolute and risk-adjusted basis. As shown in Figure 2, global PE returns have outpaced the public markets over all long-term time horizons. Moreover, investors that are able to successfully identify and access top-quartile managers stand to benefit from considerably greater returns. This strong performance, coupled with the persistent low interest rate environment across the globe, has boosted interest in PE and driven growth of the asset class.

Figure 2: PE vs. public benchmarks



Source: Cambridge Associates Buyout & Growth Equity Index and Selected Benchmark Statistics, June 30, 2016. IRR = internal rate of return. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.** Public market benchmarks are computed by assuming share purchases occur on the same dates and are of the same amounts as PE fund drawdowns, public share sales occur on the same dates as PE fund distributions, but are adjusted to be in the same proportion of public asset base NAV as distributions are of NAV. Rates of return for the S&P 500 are provided for informational purposes only and do not reflect a basis of comparison for pooled partnership investments. The market volatility, liquidity and other characteristics of PE fund investments are materially different from those of the S&P 500. The results shown are not indicative of the performance of an investment in any particular Aberdeen product.

"Across nearly all long-term time horizons, private equity has outperformed the public markets and generated strong returns on both an absolute and risk-adjusted basis."

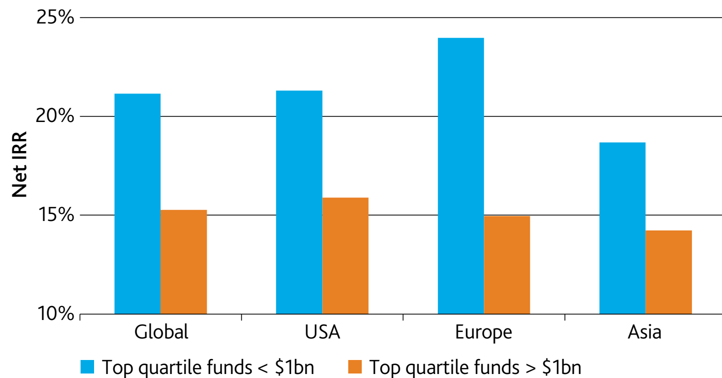

Austin, Texas

FOR PROFESSIONAL INVESTORS AND FINANCIAL ADVISERS ONLY – NOT FOR USE BY RETAIL INVESTORS

The search for outperformance

Beyond PE's headline returns, there is further outperformance potential if one can identify and access top-performing managers at the smaller end of the investment landscape. Indeed, upper-quartile funds sized less than $1 billion have outperformed their larger peers at the top quartile by nearly 600 basis points (bps) over a 10-year period, as shown in Figure 3.

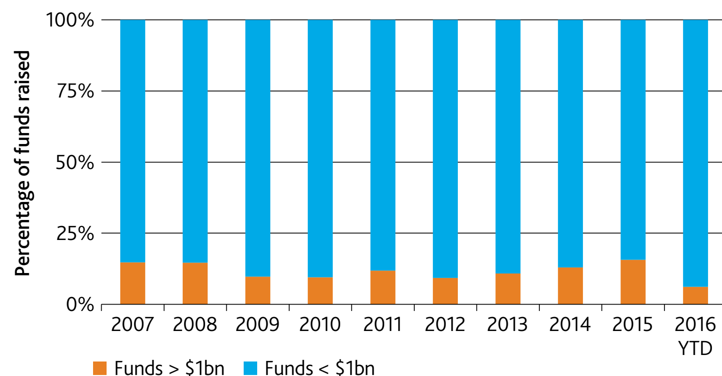
Figure 3: Top-quartile PE returns



Source: Cambridge Associates, June 30, 2016. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.** Horizon pooled returns for the period from July 1, 2006 to June 30, 2016. IRR=internal rate of return. For illustrative purposes only.

However, capturing the outperformance potential of top-quartile smaller funds is a complex endeavor, in part because of the sheer quantity of firms and funds focused on the lower middle market globally. Of the more than 3,000 funds raised since 2007, nearly 90% have been sized at less than $1 billion, as shown in Figure 4. While many of these firms are headquartered in the world's best-known financial centers – Hong Kong, London and New York – many of the most interesting smaller PE firms are located off the beaten path in cities typically not known for finance, such as Austin, Barcelona and Jakarta.

Figure 4: Funds raised by fund size

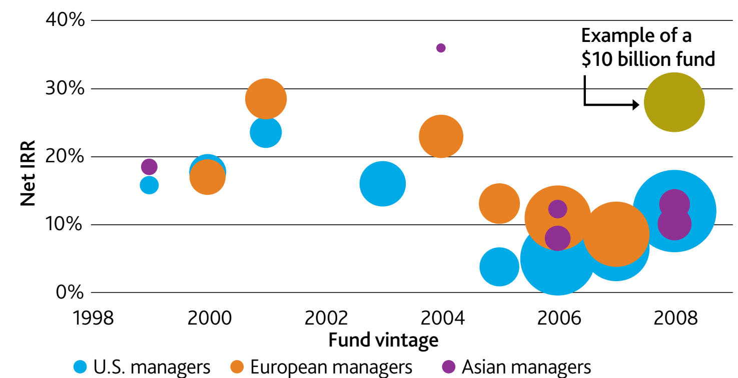


Source: Preqin, December 31, 2016. Each bar represents 100% of funds raised by buyout, growth and turnaround firms in a given year. For illustrative purposes only.

At the same time, investors who are able to successfully identify top-performing smaller managers are often confounded by the deterioration in returns that occurs as these managers scale up in size and migrate to more efficient segments of the market. Indeed, the so-called "persistence of returns" argument, which holds that top-performing PE managers have a high likelihood of delivering sustained outperformance in the future, tends to be trumped over time by the negative implications of fund size growth on performance. Importantly, this phenomenon applies to every region globally.

Anecdotally, one can see this erosion of returns by looking at the pattern of performance for a sample of well-known private equity managers anonymized in Figure 5. Over time, this particular group of general partners (GPs), whose earliest funds were quite small, have gone on to raise more than $260 billion across more than 110 funds and sub-strategies, often with deteriorating return profiles.[2] They have all certainly come a long way from the small funds on which they built their brands.

Figure 5: Distribution of returns with increasing fund sizes



Source: Preqin. Two managers selected per region. Bubbles are in proportion to fund size. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.** For illustrative purposes only.

The upshot of all this is that investors need to be forward-looking and nimble if they are to have success navigating a more mature and efficient global PE marketplace in search of outsized returns. Limited partners (LPs) simply cannot look in their rearview mirrors when making investment decisions in this asset class.

[2] Preqin and Aberdeen Asset Management analysis. For illustrative purposes only.

The global lower middle market landscape

One of the most interesting aspects of the lower middle market is its fragmented and diversified nature. There is no shortage of regional complexities, sector strategies and specialized investment approaches that must be understood.

Globally, the lower middle market is similar from one region to the next in that there is a vast pool of investment opportunities from which smaller managers with a regional focus and/or niche expertise are best positioned to access differentiated deal flow. In much the same way an American family selling its business in the Midwest is often loathe to do business with a "New York investment banker," sellers in Asia are unlikely to embrace a large global generalist firm as the proper caretaker of their business. When investing in these smaller companies, smaller managers with a local presence typically have a strong advantage over their pan-regional peers.

North America

The North American lower middle market has the largest and most diverse range of PE players. As the asset class has matured, top managers have increasingly tended to differentiate themselves through expertise in specific niches. This expertise is often borne out through industry specialization, where investment teams bring focused operating capabilities and sector-specific insights to portfolio companies. This is an especially successful approach in complex and dynamic industries such as healthcare, technology and financial services.

Managers often further differentiate themselves via a regional orientation. While not nearly as complex as the geographic differences elsewhere in the world, certain regions within the U.S. lend themselves to differentiated sourcing approaches that enable managers to see unique deal flow that is not broadly intermediated.

Beyond sector or regional approaches, the North American market also has a number of smaller PE managers focused on distinct investment styles such as buy-and-builds or turnarounds. These strategies tend to be far more specialized than traditional leveraged buyouts, allowing managers to differentiate on unique investment competencies that are hard for other managers to replicate.

Europe

In Europe, the smaller end of the PE market is also highly fragmented, but it is further influenced by distinct local norms, laws and even attitudes towards PE. While there are certainly sector and strategy specialists similar to those seen in the U.S., the top-performing managers in Europe often differentiate themselves via a country-specific focus.

Despite the rather developed nature of the European market, small managers are able to capitalize on their regional presence to generate unique deal flow. The importance of being local cannot be understated given the differences in culture, language and (often) laws across borders.

While many European cultures are open to partnering with PE investors and embracing the business plans and management change that typically follow, others have little regard for institutional investing. Regions such as the UK and Nordics tend to be rather institutionalized and well-intermediated, with top funds differentiating themselves through not only a local presence but also sourcing and operational capabilities. Other countries tend to be highly tied to specific sectors, such as oil production in Norway. And in still other areas (especially parts of Germany and Southern Europe), owners of small businesses often don't want to be seen as selling out to PE but rather partnering with well-regarded regional firms in order to maintain local credibility. Similar to the U.S., there are also distressed and turnaround specialists who differentiate themselves via expertise in local law and bankruptcy process.

Asia

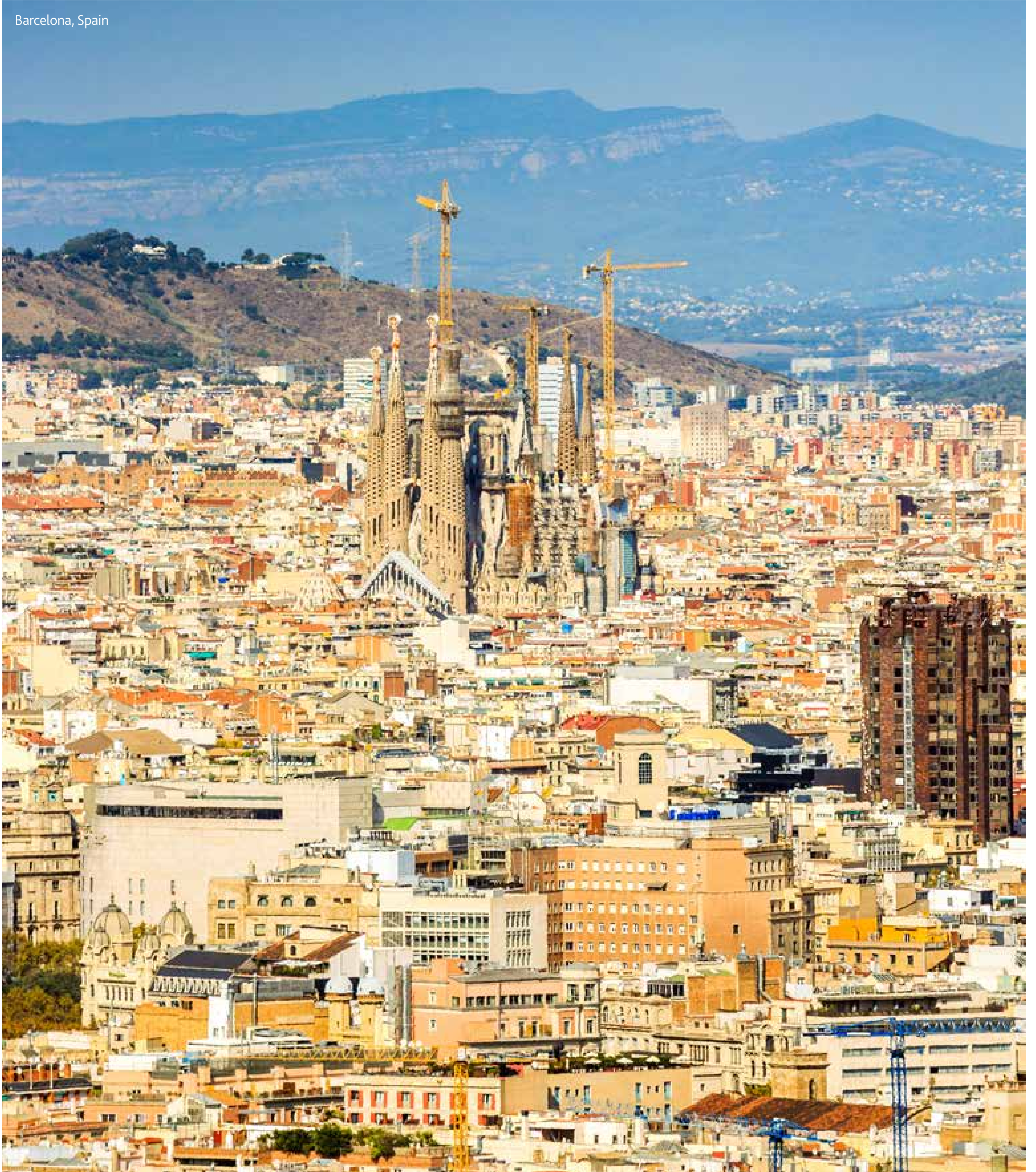
Asia is a juxtaposition of both emerging markets (such as China, Southeast Asia and India, where relatively strong markets for venture capital and growth investing feed emerging opportunities in lower middle market buyouts) and developed markets (such as Japan, South Korea and Australia, where there are well-developed lower middle market buyout opportunities).

The Chinese market – the largest by far within the Asia-Pacific region – tends to be dominated by venture and growth investing, although buyout investing continues to grow as successful entrepreneurs monetize their companies, and as state-owned enterprises continue to become privatized. Within China itself, there is increasing complexity as increased rates of team turnover are resulting in high-quality lower mid-market GP spin-outs from larger domestic and international PE firms. In India, the lower middle market PE opportunity is somewhat tempered by the ease of public market listing and the resulting tendency for private companies to command extremely robust valuations. Further opportunity and regional complexity can be found in Southeast Asian countries such as Indonesia, Singapore and Malaysia, where lower middle market investment activity continues to grow.

In Japan, there are significant opportunities in the lower middle market, particularly relating to corporate spin-outs and generational transitions in family-owned businesses. In South Korea, where local families and entities tied to large conglomerates have historically dominated the corporate landscape, firms are now emerging to focus on niche situations such as the tax implications of generational change, turnarounds and corporate spin-outs. In Australia, the buyout market is most similar to that seen in the U.S. and Europe. Interestingly, Australia benefits from being one of the most institutionalized in Asia, with strong exposure via the services sector to the rising consumer phenomenon coming out of the region's more emerging economies.

"Globally, the lower middle market is similar from one region to the next in that there is a vast pool of investment opportunities from which smaller managers with a regional focus and/or niche expertise are best positioned to access differentiated deal flow."

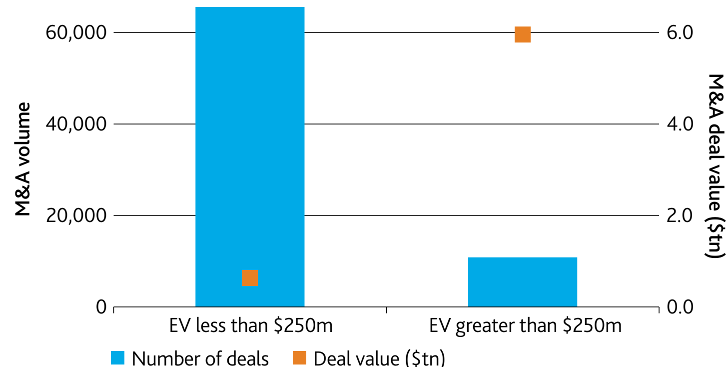
FOR PROFESSIONAL INVESTORS AND FINANCIAL ADVISERS ONLY – NOT FOR USE BY RETAIL INVESTORS


Barcelona, Spain

Unlocking value in the lower middle market

The origins of lower middle market investments can take many forms. Some are successful founder-run businesses in search of first-time institutional capital to manage generational change or to fund growth initiatives, while others may be more complex transactions involving local bankruptcy law or non-core divisions spinning out of larger corporations. Given the sheer volume of deals at this end of the market (as shown in Figure 6), it is a segment of the investment landscape that tends not to be well-intermediated, with a legitimate opportunity to find the elusive "proprietary deal." Furthermore, this is a part of the market that sees robust transaction activity regardless of macroeconomic trends, credit availability or public market volatility. The lower middle market is a vibrant ecosystem where small business owners are constantly looking for some combination of liquidity, financing to fund growth initiatives and operational assistance to improve their businesses.

Figure 6: Global M&A transactions by enterprise value (EV)



Source: PitchBook M&A Report, Q3 2013-Q3 2016. For illustrative purposes only.

Globally, lower middle market PE managers tend to generate investment returns via two fundamental value creation initiatives: growth and multiple expansion. Driving tangible change in underlying portfolio companies requires PE managers to have a specialized skill set coupled with day-to-day involvement with the company's operations. These specialized skills can include everything from granular operating expertise to an ability to execute on complex financial transactions.

While the use of leverage – a staple of larger PE investments – is within the playbook of lower middle market managers, it is generally not a core tenet of value creation. In fact, it isn't unusual to see little, if any, debt in smaller PE investments. Deals that do take on leverage do so generally 1-2 turns[2] below the average of larger deals (as shown in Figure 7). This lower debt burden makes lower middle market investments less susceptible to balance sheet risk and generally offers more operational flexibility and financial stability.

What most, if not all, successful lower middle market private investors have in common is the capability to fundamentally improve and grow businesses. Smaller companies are often under-managed and sub-scale, presenting significant opportunities for value enhancements. Growth can come from a variety of channels, including sales and marketing initiatives, product extensions, entry into new markets and add-on acquisitions. Means of building value often include expanding product/service offerings, enhancing operational processes and systems, augmenting management teams, redefining corporate strategy, identifying profit margin improvement opportunities and building new industry partnerships/verticals. Opportunities for even deeper restructurings exist in distressed and turnaround situations. By spearheading these types of changes, PE managers can institutionalize their portfolio companies, help them gain scale and improve operating efficiency.

When it comes time to exit an investment, lower middle market PE managers are often able to realize multiple expansion - that is, the ability to sell a business at a higher valuation multiple relative to the purchase price multiple at entry. On the back of the value creation initiatives previously discussed, PE managers stand to benefit from selling a larger, better run and more diversified business – all of which drives a premium multiple. Further, there is no shortage of exit alternatives for smaller deals, whether it be selling to strategic buyers, financial buyers or the portfolio companies of larger PE firms.

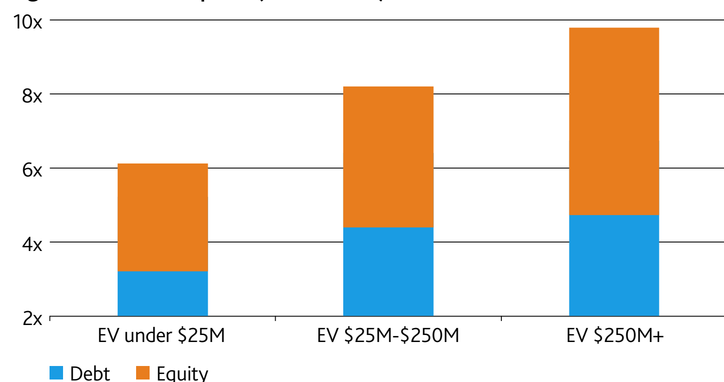
"...this is a part of the market that sees robust transaction activity regardless of macroeconomic trends, credit availability or public market volatility."

[2] A turn of leverage refers to a company's debt-to-EBITDA leverage ratio. For example, three turns means the company's leverage ratio is 3x. EBITDA is earnings before interest, taxes, depreciation and amortization.

FOR PROFESSIONAL INVESTORS AND FINANCIAL ADVISERS ONLY – NOT FOR USE BY RETAIL INVESTORS

However, much of the fundamental attractiveness of lower middle market investing relates to the inefficiency in this segment of the market, which allows managers to buy companies at compelling valuations in the first place. Indeed, the lower middle market consistently offers the best relative value due to favorable supply/demand dynamics and the simple fact that many deals are not widely shopped in competitive auctions. As highlighted in Figure 7, the smallest deals (less than $25 million of enterprise value) tend to trade at purchase price multiples that are three to four times less than at the larger end of the market.

Figure 7: Purchase price (EV/EBITDA)



Source: PitchBook, Global Private Equity Deal Multiples Report: II, Q2 2016. Debt, equity and enterprise value as multiples of EBITDA. For illustrative purposes only.

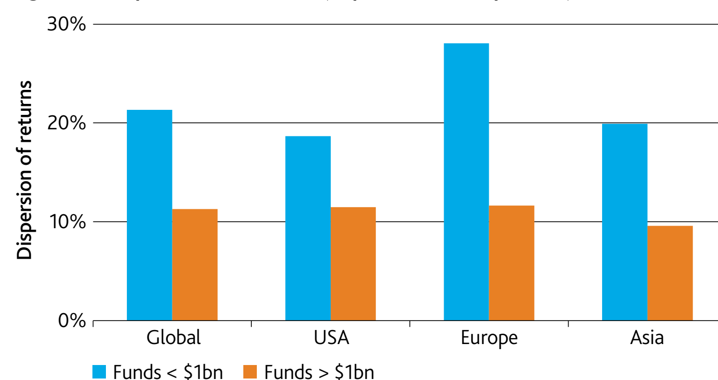
Considerations for accessing the global lower middle market

While there are myriad benefits to investing in the global lower middle market, investors must be cautious and thoughtful when considering PE manager selection. To this point, several key factors should be top of mind when building a global portfolio.

First, the PE universe is immense, with nearly 3,000 funds raised over the last decade. Nearly 90% of these funds are sized less than $1 billion – a common proxy for the lower middle market.

Second, while smaller funds have outperformed larger funds, the dispersion of returns within the lower middle market is considerably wider. As highlighted in Figure 8, the spread between top and bottom quartile sub-$1 billion funds is 2132 basis points (almost twice the dispersion of larger funds).

Figure 8: Dispersion of returns (top vs. bottom quartile)



Source: Cambridge Associates, June 30, 2016. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.** Horizon pooled returns for the period from July 1, 2006 to June 30, 2016. Dispersion of returns has been defined as the difference between the 75th and 25th percentile of the net IRR. For illustrative purposes only.

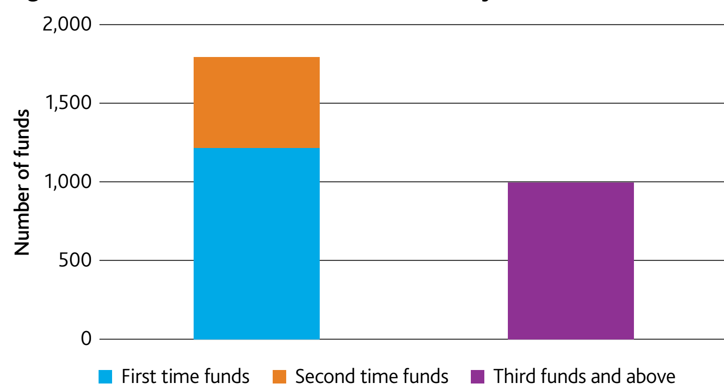
This dispersion can be attributed both to the general complexities of lower middle market investing as well as to the wide range of quality across PE GPs. Investors seeking to capitalize on the return potential of small-cap PE will be sorely disappointed if they select the wrong lower middle market manager.

Copenhagen, Denmark

FOR PROFESSIONAL INVESTORS AND FINANCIAL ADVISERS ONLY – NOT FOR USE BY RETAIL INVESTORS

Third, adding to the importance and complexity of global manager selection is the fact that the persistence of returns in the PE asset class is eroding. The approach of backing managers with strong historic returns no longer guarantees future success. In fact, a recent study by Cambridge Associates showed that 84% of the top ten top-quartile funds across a recent nine-year period were managed by emerging or developing funds (Fund I-IV),[3] rather than well-established "proven managers." Given that 64% of funds that have come to market since 2007 are either Fund I or II (as shown in Figure 9), it is important that investors are well plugged into markets across the globe and constantly monitoring new fund formation.

Figure 9: Number of funds raised since 2007, by vehicle number



Source: Preqin. Fund types: Buyout, growth and turnaround funds for the period from January 1, 2007 to December 31, 2016. For illustrative purposes only.

Finally, and perhaps most importantly, PE fund investing in the lower middle market is a relationship business that requires on-the-ground, local presence in order to achieve the most success. Regardless of geography, the best-performing managers will rarely seek out investors; instead, investors must find them. For this reason, it is essential to develop relationships with firms early in their evolution before others are knocking on their doors.

Additionally, the global market is comprised of a complex network of interconnected but regionally diverse countries where rule of law and the keys to successful investing vary across borders. It is vital to back managers with both relevant skills and strong local knowledge. It is not hard to appreciate the vastly different skills needed to invest globally. Whether performing due diligence on an opportunity in China, structuring a deal in Indonesia or taking a small company private off a public exchange in Poland, the requisite skills are unique and specialized. Thus, investment teams building global portfolios must understand the cultures, speak the languages, meet with managers regularly and have the perspective of monitoring the investment landscape through multiple cycles.

Summary

The global PE landscape has evolved immensely over recent years, driven by the strong return profile of the asset class. Regardless of where they are located, managers investing in the lower middle market have shown an ability to outperform their larger brethren – a trend that improves further for investors who can identify and access top managers. However, to capture the return potential of the lower middle market, investors must understand the nuances of the global PE market and have local teams with deep regional networks. These relationships, together with an understanding of local markets, allow investors to access the best-performing managers and have the opportunity to generate consistent outperformance.

Given all the complexity associated with lower middle market investing on a global basis, appropriate diversification and portfolio composition across both geographies and strategies are key risk mitigation tools. Pairing this with a thoughtful manager selection approach opens the door to partnering with top-performing PE firms and the potential for alpha generation.

[3] Cambridge Associates – The 15% Frontier (July 2016).

At Aberdeen, asset management is our primary business

Aberdeen Asset Management is a global asset manager. Today, we manage more than US$405.4 billion for institutional investors and private clients, as of September 30, 2016. Our institutional clients include retirement plans, state and local governments, hospitals, insurance companies, multiemployer plans, endowment and foundations, and other institutional investors. We engage with all clients using a consultative approach focusing on a rigorous investment discipline, risk control, and a commitment to transparency.

IMPORTANT INFORMATION
PAST PERFORMANCE IS NOT AN INDICATION OF FUTURE RESULTS
FOR PROFESSIONAL INVESTORS AND FINANCIAL ADVISERS ONLY – NOT FOR USE BY RETAIL INVESTORS
Investing involves risk, including possible loss of principal.

Among the risks presented by private equity investing are substantial commitment requirements, credit risk, lack of liquidity, fees associated with investing, lack of control over investments and or governance, investment risks, leverage and tax considerations. Private equity investments can also be affected by environmental conditions/events, political and economic developments, taxes and other government regulations.

The above is for informational purposes only and should not be considered as an offer, or solicitation, to deal in any of the investments mentioned herein. Aberdeen Asset Management (AAM) does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document, and expressly disclaims liability for errors or omissions in such information and materials.

Some of the information in this document may contain projections or other forward looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document, and make such independent investigations, as he/she may consider necessary or appropriate for the purpose of such assessment.

The information set forth in this document shall not constitute an offer, solicitation or recommendation to sell or an offer to purchase any securities, investment products or investment advisory services. Such an offer may only be made to qualified investors by means of delivery of formal, confidential offering materials.

The views and opinions expressed are provided for general information purposes only, and do not constitute specific tax, legal, or investment advice to, or recommendations for, any person. Information provided should not be relied on by the reader as financial or investment advice and does not take into account the particular financial circumstances of an investor. As such, neither AAM nor any of its agents have given any consideration to nor have they made any investigation of the investment objectives, financial situation or particular need of any specific person or group of persons. Prior to any investment decision, you should obtain independent professional advice regarding your specific circumstances.

AAM reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

In the United States, Aberdeen Asset Management (AAM) is the marketing name for the following affiliated, registered investment advisers: Aberdeen Asset Management Inc., Aberdeen Asset Managers Ltd, Aberdeen Asset Management Ltd, Aberdeen Asset Management Asia Ltd and Aberdeen Capital Management, LLC. Excluding Aberdeen Capital Management LLC, each of these advisers are wholly owned by Aberdeen Asset Management PLC. Aberdeen Capital Management LLC is a wholly-owned subsidiary of Aberdeen Asset Management Inc. “Aberdeen” is a U.S. registered service mark of Aberdeen Asset Management PLC.

Aberdeen Asset Management (“AAM”) is the marketing name in Canada for the following affiliated entities: Aberdeen Asset Management Inc., Aberdeen Fund Distributors, LLC, Aberdeen Asset Management Canada Limited and Aberdeen Capital Management, LLC. Aberdeen Asset Management Inc. is registered as a Portfolio Manager in the Canadian provinces of Ontario, New Brunswick, and Nova Scotia and as an Investment Fund Manager in the provinces of Ontario, Quebec, and Newfoundland and Labrador. Aberdeen Asset Management Canada Limited is registered as a Portfolio Manager in the province of Ontario. Aberdeen Fund Distributors, LLC, operates as an Exempt Market Dealer in all provinces and territories of Canada. Aberdeen Fund Distributors, LLC, Aberdeen Asset Management Canada Limited and Aberdeen Capital Management, LLC, are wholly owned subsidiaries of Aberdeen Asset Management Inc. Aberdeen Asset Management Inc. is wholly owned by Aberdeen Asset Management PLC.

Aberdeen Asset Management Inc. 1735 Market Street, 32nd Floor Philadelphia, PA 19103 Telephone: (800) 485-2294 aberdeen-asset.us

Aberdeen Asset Management Inc. 1266 East Main Street, 5th Floor Stamford, CT 06902 Tel: (203) 352-0440

Aberdeen Asset Management Inc. One Beacon Street, 23rd Floor Boston, MA 02108 Tel: (617) 557-0028

Ref: 24533-050117-1
024283-0117-PHL
SEG MIDDLE CLASS-WP

Aberdeen