Active Microcap: An Alternative to Private Equity

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Summary

Assets allocated to private equity ("PE") strategies have soared in recent years, with little evidence of a slowdown. What began as a strategy primarily utilized by large and sophisticated endowments has increasingly become commonplace in institutional portfolios. An era of budgetary setbacks, increased funding requirements, sluggish hedge fund returns, and historically low yields have pushed many allocators to seek private equity's historically high absolute returns as a means of alleviating funding challenges. More recently, PE allocations have even been popping up in portfolios of many high-net-worth individuals as general partners ("GPs") have reduced investment minimums to raise larger and larger funds. As a result, private equity continues to set fundraising records year after year, resulting in excess capital competing for a scarce supply of deals. Given this dynamic, we think PE will be an increasingly challenging space for many investors, as it will be difficult for PE to deliver returns commensurate with the risks it presents. This is particularly true for those allocators with limited expertise and a less robust PE network. Given the challenges, we believe an allocation to active microcap strategies is an appealing alternative over allocating to PE, providing the benefits of a PE allocation without many of the associated risks:

- Over the long run active microcap managers have delivered total returns that are comparable to those from private equity managers.
- Active microcap managers have been able to deliver these comparable returns with lower fees, less risk, no lockups, full transparency, and greater liquidity.
- Historical absolute return patterns (periods of strength and weakness) have been similar, meaning microcap managers provide similar diversification benefits to PE.
- Research suggests that the increasing use of subscription lines of credit ("SLCs") artificially inflate PE returns while meaningfully increasing fund leverage.
- Expertise and fund selection matters. A significant return gap exists between the returns of top-tier private equity allocators with less selection expertise.
- Record levels of unallocated capital in private equity poses challenges for future return prospects. Additionally, it should lead to elevated merger and acquisition activity in public markets, which will continue to drive returns for active microcap.

Background

The core reasons for the explosive growth in PE are quite simple: allocators are attracted by the prospects of higher returns that also provide diversification benefits to their existing portfolios. This, of course, is easier said than done. Effective investing in private equity requires a degree of expertise, sophistication, scale, and resources that can be difficult for many institutions to come by, putting most investors at a disadvantage to private equity investors that have those skills. Additionally, private equity strategies come with several unique risks and challenges relative to public equity, including less transparency, limited liquidity, higher fees, and the potential need for additional strategies to handle uncalled capital. Given these additional hurdles and risks, it should be expected that PE allocations would provide a meaningful return premium over public equities. Unfortunately, the assumed return premium associated with an allocation to PE has not been realized by many investors. Since the Global Financial Crisis, public equity returns have kept pace with private equity. Despite this, private equity funds continue to experience record inflows year after year, leading to trillions of dollars in unallocated capital. With the similar returns public equity has provided, the unique skillset needed to successfully invest in private equity, and the potential forward looking performance headwinds PE funds face in the near future, it begs the question: “Is there a better solution to private equity?”

We believe active microcap provides a strong alternative to private equity allocations. Active microcap provides many of the similar return and diversification advantages that make private equity appealing to investors, however it does so without most of the associated risks and challenges. In addition to the historically meaningful absolute return premium from investing down the market cap spectrum (the “small cap premium”), microcap stocks are disproportionately underfollowed by sell side brokers and under owned by institutional investors. This inefficiency is even more powerful than the small cap premium, providing a lucrative landscape for active managers to generate strong excess returns on top of the powerful market beta provided by the small cap premium. At the company level, the fundamental characteristics of target investments preferred by active microcap managers are quite similar to the characteristics preferred by private equity investors, causing the underlying investments to often be quite similar. In fact, active microcap managers invest in many of the same stocks that private equity managers ultimately target to take private. Given the comparable return patterns of active microcap, similar investment characteristics, uncertainty in the forward-looking PE landscape, excess supply of capital flooding PE funds, and the significantly fewer risks that come with microcap, we think an active microcap allocation provides an appealing alternative to private equity for many investors.

Active Microcap vs. PE: Similar Historical Absolute Returns

A number of large endowments with investment policies focused on absolute returns were early to embrace private equity, and many were rewarded with appealing returns. An important advantage those allocators had was that their endless time horizon provided them the ability to accept the lack of liquidity from an allocation to private equity. Over time, a number of additional groups – including corporate and public pension plans – have added and/or increased their allocation to PE, causing a fundraising frenzy. This has directly led to what we believe to be one of the difficulties that private equity has faced in recent history (and will continue to face moving forward) – overcrowding. In our view there is simply too much money competing for too few attractive investment opportunities. This has left large amounts of capital on the sidelines and driven up competition for deals, which inflates entry multiples. The net effect has been a deterioration of the historical return premium PE has enjoyed relative to public equity markets.

Given that private equity returns have not entirely compensated investors for the additional risks and illiquidity in recent years (Exhibit 1), institutional investors have and should seek out alternatives. From an asset class perspective, we believe that microcap's similar returns make it a logical replacement for PE. Additionally, microcap has the added benefit of avoiding many of the risks, illiquidity, extremely high fees, and operational challenges associated with a PE allocation. However, passive microcap solutions are far from optimal (see our earlier paper *"U.S. Microcap: The Passive-Immune Asset Class", 2018,* for an in-depth look at this dynamic) and miss out on the excess return potential of microcap. Therefore, we believe that *active* microcap managers offer an excellent proxy for private equity.

Exhibit 1 below compares the trailing returns of private equity, active microcap, and public equity indexes (a proxy for passive returns) over the last 25 years. Unsurprisingly, active microcap managers have had long-term returns that easily surpass all large, small, and microcap benchmarks. Most notable however is that active microcap has performed essentially in-line with private equity over the long run (slightly ahead over the last 20 years, slightly behind over the last 25), which calls into question the assumed return premium of private equity.

**Note: As of this writing, 2020 returns for PE are still months away from being available. For the sake of consistency, throughout this paper returns are shown through 2019.*

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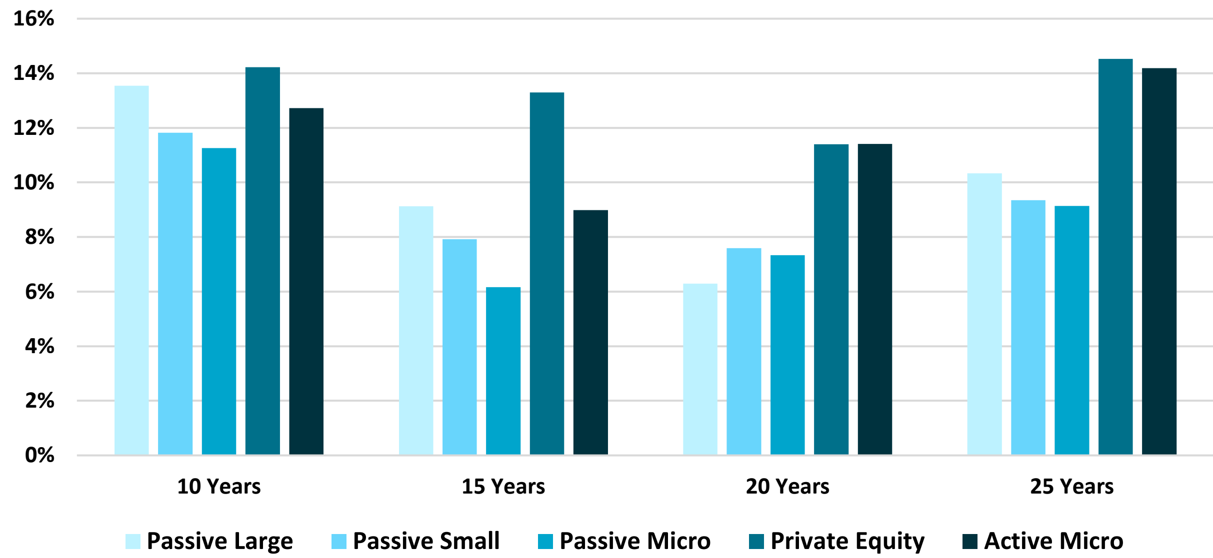
Exhibit 1: Public vs. Private Equity Returns, Net of Fee
Annualized through 12/31/2019



Source: Acuitas, Cambridge Associates, FTSE Russell, eVestment Alliance, FactSet
Private Equity returns are reported by Cambridge Associates net of management fee.
Active Micro returns assume an estimated 1% annual management fee.
The inception of the Russell Microcap Index is 2001. Passive Micro/Small Cap uses the Russell 2000 Index for periods prior to 2001. It is not possible to invest directly in an index.

When looking at the more recent time periods in Exhibit 1, it is worth addressing the multiple clear and significant headwinds working against microcap. First, despite the long-term absolute return premium provided by microcap stocks, large cap equities have been on an incredible run of late and kept pace with private equity returns. This should come as no surprise as the performance of the 'FAANG' stocks (among others) have become one of the most recognizable and discussed market trends over the past decade. Throughout 2019 the trailing one-year spread between U.S. microcap and large cap was the largest it has ever been since the inception of the Russell Microcap Index, with microcap lagging by more than -20%. Incredibly, by year end there were half a dozen individual stocks with market capitalizations greater than the total combined market cap of every company within the Russell Microcap Index. In our view, this recent outperformance of large cap is a short-term cyclical event, and the long run return relationships are likely to hold going forward.

Exhibit 1 also shows that PE returns over the trailing 15-year period (2005-2019) were meaningfully higher than all public equity tiers. The key driver of this was the Global

Financial Crisis (the “Crisis”), where public equity markets were cut in half as investors ran for the exits, selling off any liquid assets they could. Due to the nature of private equity and the associated lack of liquidity, investors were unable to liquidate their private equity positions as they were in public markets. Effectively, public equities were ‘marked to market’ during the crisis, while the private equity valuations were artificially smoothed. This smoothing of returns directly contributes to the often-cited diversifying/uncorrelated return pattern of PE, however a bulk of it is artificial in nature.

A similar dynamic also played out more recently in the fourth quarter of 2018, which was brutal for public equities. Unsurprisingly, private equity products held up quite well during the fourth quarter of 2018 public market volatility because they were not marked to market, leading to PE products outperforming active microcap equity by the largest quarterly margin in the entire 25-year data set (and the second largest margin when compared to large cap). Despite periods of short-term outperformance for private equity such as the Global Financial Crisis and fourth quarter of 2018, we feel that the nearly identical long-term performance of active microcap relative to PE is a more accurate representation of how these two asset classes behave.

Active Microcap vs. PE: Similar Historical Return Patterns

In addition to providing comparable total returns to private equity over the long-term, the return patterns of active microcap managers also tend to mirror the return pattern of private equity (i.e. high correlation). In the chart on the next page (Exhibit 2) we have demonstrated that PE and active microcap returns trend in the same direction and enjoy similar periods of difficulty and success.

The primary differences between the return series in Exhibit 2 are a function of the severity of each peak and valley. It is worth reiterating that the lower volatility of reported private equity is driven in part by inherent biases that artificially smooth return streams. These include – but are not limited to – confirmation bias, survivorship bias, infrequent and stale pricing, and the reliance on self-reported appraisals that are anchored to prior period valuations. Conversely, microcap stocks can be bought or sold daily in the public markets and are priced in real-time throughout each trading day, making accurate daily returns readily available. As a result, microcap returns lack the biases that artificially smooth the private equity returns. Conversely, the artificially smoothed PE returns in the chart are not achievable in the real world because the holders would not be able to sell their positions due to lockups, illiquidity, or lack of buyers during distressed markets.

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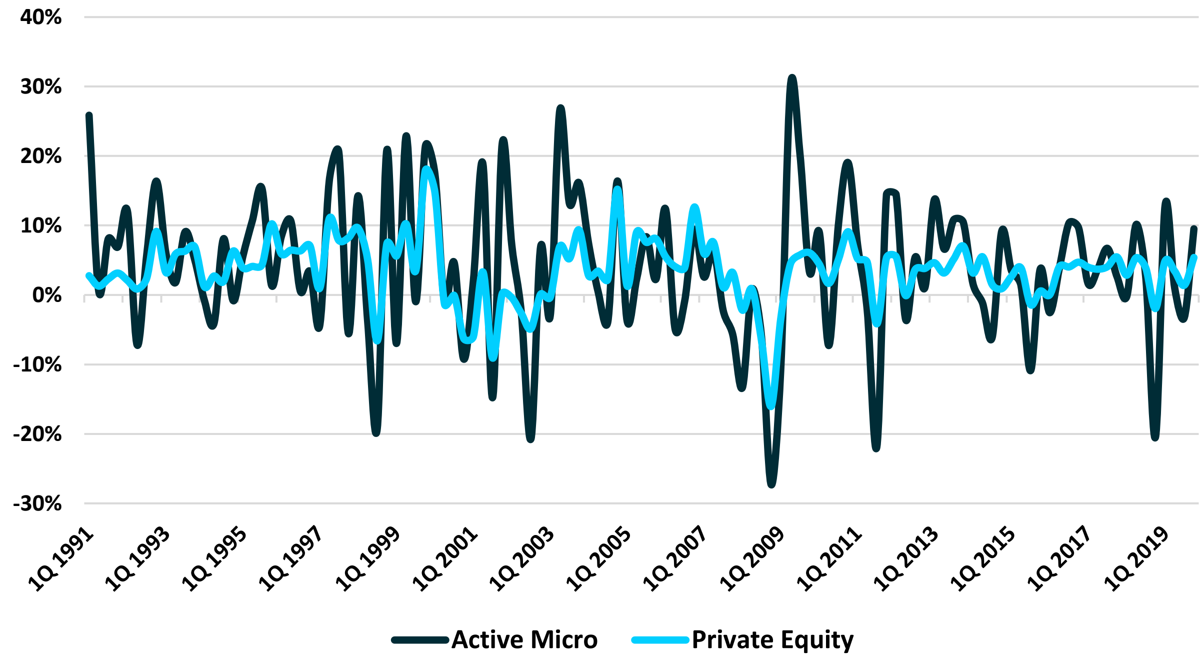
Exhibit 2: Quarterly Returns of Private Equity vs. Active Micro
1Q 1991 to 4Q 2019



Source: Acuitas, Cambridge Associates, FTSE Russell, FactSet

While the absence of lockups is a significant advantage for investors in active microcap, it is important to acknowledge an advantage that lockups can provide. During periods of excess volatility lockups prevent investors from panic selling at the worst time, which in a sense helps save investors from themselves. This in turn reduces their exposure to market cyclicality, contributing to the appearance of lower volatility. The Crisis example discussed earlier highlights this dynamic, as the 2008 selloff and subsequent rebound are quite pronounced in Exhibit 2. Lockups and the illiquid nature of PE provided a “floor” to the sell off, but also a cap on the rebound, which is a perfect example of ‘smoothing’. Conversely, microcap declined to a larger degree than PE during the peak of the Crisis but rebounded far more aggressively coming out of the Crisis.

In a recent paper from State Street and MIT Sloan, Czasonis et al. (2020) determined that after adjusting for smoothing, private equity volatility is essentially equal to public equity volatility. When looking at Exhibit 2, if we were to amplify the volatility of the private equity returns to reduce the artificial smoothing, the correlation with active microcap would only increase. Historically speaking, asset allocators have expected private equity to generate returns of 3-5% over public equity, net of fees. When considering the long-term beta premium provided by microcap (based on Fama-French’s work) and the additional alpha generated by active managers, the active microcap space tends to offer a premium over the broad public equity market within the same 3-5% range as well. The highly correlated nature of the return strings coupled with similar long term absolute returns highlight just how strong of a proxy active microcap is for private equity. The key takeaway from Exhibit 2 is that despite the illusion of reduced quarter-to-quarter volatility within PE, the returns are highly correlated with active microcap. For allocators that seek out PE due to the reputation of it being a diversifying asset class, they should be aware that active microcap offers similar diversification benefits.

Earlier we touched on the impact that artificial smoothing of returns had during the Global Financial Crisis (Exhibits 1 and 2). Extreme markets such as those experienced during and after the Crisis also amplify the impacts of other biases in returns. For example, given how much leverage is involved in PE, a financial crisis the scale of 2008 caused a number of PE firms to go under. However, due to the voluntary nature of reporting returns, firms that went under are unlikely to submit their returns to be included in Cambridge's Private Equity Index, causing the Index to be distorted toward firms that survived and/or did well in the crisis. There is an element of this as well for active public equity returns, however it is far more muted than it is for PE. For investors looking to allocate assets to PE now, it is impossible to guarantee that their investment will be in one of the funds that survives the next crisis.

"New" Biases in Private Equity Returns

In addition to long-standing biases that misrepresent PE's return history, recent research has brought to light "new" sources of biases influencing PE returns that are worth highlighting in order to provide additional context when assessing how strong of a proxy active microcap is for private equity. In a recent trend, the use of subscription lines of credit by private equity funds has exploded. This expanded use has introduced another unique source of bias in returns for private equity. At a high level, SLCs are a debt instrument used by PE funds where the collateral on the loans is the uncalled capital of limited partnerships ("LPs"). This allows GPs to delay capital calls and draw on their SLC to fund deals, then pay back the loan at later dates by calling on the collateralized uncalled capital of LPs.

Professor Albertus and Professor Denes of Carnegie Mellon took a deep dive into the impacts from this new and increasingly popular source of capital in their recent paper *Distorting Private Equity Performance: The Rise of Fund Debt*. Their work found that the total value of SLCs has increased from $86 million in 2014 to over $7 billion in 2018 on an annualized basis (an increase of more than 82x). There are a number of consequences as a result of this, one of which is that average leverage of funds has nearly tripled over that same time period, increasing from 11.8% in 2014 to 31.1% in 2018. Second – and most important to the topic at hand – is that the use of SLCs meaningfully distorts private equity fund returns without changing any of the underlying investments nor the results of

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those investments. Based on their work, Denes and Albertus found that IRR-based performance for funds using SLCs increased by 6.1% simply due to the way IRR is calculated: being able to invest in deals before capital calls increases the effective leverage and therefore increases IRR. Looking beyond IRR, multiples-based performance measures such as total value paid-in capital ("TVPI") are popular due to providing a more accurate assessment of LP's returns per dollar invested in the fund. Their work highlighted that the average impact on TVPI from the use of SLCs was *negative* due to the costs of interest and fees on the loans. To be clear, the ability for capital calls to be smoothed, delayed, and at times more predictable can be advantageous for LPs from an implementation standpoint. However, in terms of returns in private equity, the use of SLCs decreases TVPI and artificially inflates IRR, which is an important distinction to consider when assessing potential alternatives to private equity.

Another more recent discovery was published in the Journal of Alternative Investments by Czasonis et al. (2019). They found that trailing private equity returns are influenced by future public equity returns. The reason for this is that it typically takes a few months after quarter end for PE firms to value their investments and self-report returns. In periods where public markets performed well during the delay between quarter end and when PE returns are self-reported, the authors found that private equity managers tend to inflate historical valuations (and therefore historical performance), despite the valuation date being *prior* to the time period of positive public market performance. Conversely, if public markets underperform during the reporting delay, PE managers are not nearly as likely to lower historical valuations. The most meaningful impact for this discussion is that this newly found bias provides additional smoothing pressure on PE return strings, which directly contributes to the artificially low volatility.

The main takeaway here is to highlight that PE returns are difficult to interpret at face value from a number of angles. Despite the numerous biases in returns – both widely accepted and newly discovered – active microcap continues to provide similar returns without being influenced by these biases and artificial skewing of the returns.

Historical Success - Realized Private Equity Returns Vary

Less tangible, but equally important to having success in private equity is whether allocators and investors have the necessary skill, experience, and relationships to effectively identify and invest with strong private equity managers. Without these skills, allocators will have a difficult time realizing returns in-line with expectations. Specialized experience, strong networks, and access to top tier private equity managers are critical drivers of successful investments in private equity. These characteristics are what can differentiate effective private equity allocators from those that deliver mediocre or poor returns. In Josh Kosman's book "The Buyout of America", David Thomas, a Managing Partner of Court Square Capital Partners, said "The reason everyone focuses on top quartile is because if you are in the high end of the second quartile, you might as well be in bonds. And if you are in the middle or low end of the second quartile, you might as well be in a CD. And anything below that [median/50 percent] and you are losing money." Point being, choosing which PE fund to invest with is a critical decision, but doing so is quite difficult.

A study by Lerner, Schoar, and Wong (2005) attempted to identify success characteristics for various subsets of private equity allocators, and while the study is admittedly dated, the study identified an interesting dynamic. It found that between 1991 and 2001 endowments earned an average of 20.5% in their private equity portfolios, while public pensions and corporate pensions earned 7.6% and 5.1%, respectively. The magnitude of that return spread is alarming, as endowments earned on average 4x the return of corporate pensions (20.5% vs 5.1%). This supports the idea that endowments – as the early wide-scale adopters of private equity – were able to build up superior expertise, experience, and networks that led to greater success with their private equity allocations and individual fund selection. Unfortunately, it is difficult for newer entrants to replicate the level of skill those institutions have, particularly in today's crowded private equity space.

To be clear, we firmly believe that private equity can be a valuable asset class that has a place in many investors' portfolios. There are a number of organizations that have developed superior skill in private equity investing, and many of those entities have had success allocating to PE funds. Additionally, there are some allocators who simply have a natural competitive advantage when it comes to accessing the best PE funds. This advantage typically comes with scale and a strong network, as the largest allocators tend to be the "first call" for new funds from the most talented PE firms.

Smaller, less sophisticated allocators in PE are often left in the dark and locked out from accessing many of the top tier funds. As such, their universe of potential PE funds to invest in becomes tilted towards funds that the top tier allocators have already passed on. It has also become increasingly difficult for many institutions to develop these necessary skills, especially given the recent trend of consolidation and budget cuts aimed at headcount reduction. Increased reliance on outsourcing of research via consultants and/or outsourced CIO models is another challenge that allocators face. For those allocators that lack scale and/or the expertise to successfully invest in PE, active microcap provides an excellent alternative.

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Microcap and Private Equity Managers Seek Similar Investment Characteristics

While success rates and returns experienced by allocators vary, on average the returns between active microcap and private equity are quite comparable. An important driver of the highly correlated return patterns of PE and active microcap is that they both prefer similar characteristics in their investments. This naturally leads them to buy comparable – and sometimes the same – companies, which drives the similarities in returns.

Most notably, private equity managers often target small, niche, undiscovered companies with appealing business characteristics that are underfollowed and undervalued by the marketplace. This same definition describes many of the companies found in public microcap. Like private equity funds, an active microcap product can offer a concentrated, high-conviction portfolio of investments carefully selected from an inefficient, minimally researched pool of companies. This ultimately leads to a portfolio of public companies with meaningful return potential. Additionally, microcap and PE investors share many beliefs about which fundamental characteristics make a company an attractive investment. Generally speaking, active microcap managers tend to favor strong cash flow generation, limited leverage, and stable business fundamentals. All of these characteristics are commonly recognized as attributes that private equity managers also favor. Many stocks that active microcap managers target also tend to be inexpensive based on metrics that private equity general partners use to value companies, such as EV/EBITDA. In fact, many active microcap managers specifically aspire to "think like a private equity investor" when evaluating investment opportunities.

In Exhibit 3 below, we demonstrate this very dynamic. To do this, we created tertiles (split the index into three buckets) for the Russell Microcap Index on two dimensions: by EBITDA/EV (a measure of valuation) and by dept/capital (a measure of leverage). We then measured the over/under weight of active microcap managers' portfolios to each of these nine buckets (3x3) relative to the benchmark index's weight in those same buckets. The end result is a heat map of where the typical investments active microcap managers are biased toward across these two popular elements of PE investing. Areas where managers are overweight compared to the benchmark indicate a preference for those characteristics, while an underweight suggests avoidance. As a proxy for active microcap, we used the Acuitas Microcap Composite, which includes a dozen different active microcap managers spanning the style spectrum (deep value to aggressive growth) and investment process (fundamental and systematic).

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Exhibit 3: Active Microcap Investment Characteristic Preferences
As of 12/31/2019

	High EBITDA/EV		Low EBITDA/EV
Low Debt/Cap	3.0%	7.3%	-12.2%
	10.4%	1.6%	-4.5%
High Debt/Cap	0.4%	-1.7%	-4.4%

Least expensive, lowest leverage

Most expensive, highest leverage

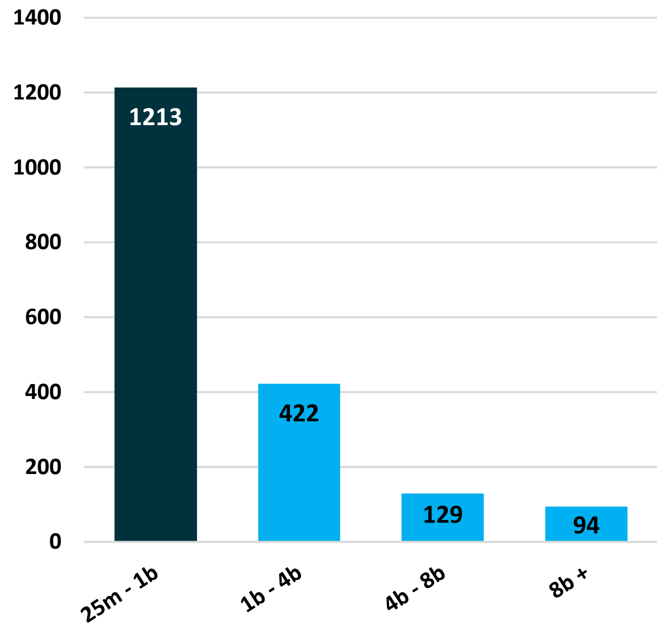
Source: Acuitas, FactSet. Percentages in the table are based on the relative over (green) / under (red) weight of the Acuitas Microcap Composite relative to the Russell Microcap Index as of 12/31/19.

What is clear is that active microcap managers tilt their portfolios toward companies that exhibit the same fundamental characteristics PE firms target for their investments. Cheap companies (high EBITDA/EV) and low leverage (debt/cap) are heavily favored characteristics, while the inverse characteristics (expensive, high leverage) are generally avoided. These overlapping preferences extend well beyond just these two metrics as well, which ultimately contributes to the similar returns and correlation. Additionally, the universe of companies from which the two select from often overlap as well. As a result, microcap companies being acquired at a premium to their public market price is an important driver of returns for active microcap managers.

Mergers & Acquisition Activity

M&A is a critical component of both private equity and public microcap investing. Nearly two-thirds of all public companies who were M&A targets over the last decade have been microcap (sub-$1B) companies, as shown in Exhibit 4 below. Of course, there are more securities in the smallest market cap buckets, so the larger number of takeouts on an absolute basis is to be expected. To account for that, the table in Exhibit 4 shows the number of takeouts as a percentage of the universe size using the total number of securities in the Russell 3000E Index within each bucket (as of 12/31/19). When compared to every other market cap tier in public equity, microcap stocks are acquired more frequently on both an absolute and relative basis.

Exhibit 4: Completed and Pending Mergers/Acquisitions by Market Capitalization
10 years ending 12/31/2019



	Deals as a % of Companies in R3000E
25m - 1b	79%
1b - 4b	47%
4b - 8b	38%
8b +	15%

Source: Acuitas, FactSet. Percentages in the table are based on the total number of takeouts between 12/31/2009 and 12/31/2019 relative to the total number of securities for the corresponding market cap bucket within the Russell 3000E Index as of 12/31/2019

In addition to the increased frequency of acquisitions within the microcap space, the premiums paid tend to be meaningfully larger as well. As such, active microcap managers who owned stocks that were acquisition targets have benefitted from the higher prices paid by acquirors. This is particularly true for those companies below $250 million in market cap, where the 30-day premium has averaged 45% over the ten-year period ending December 31, 2019.

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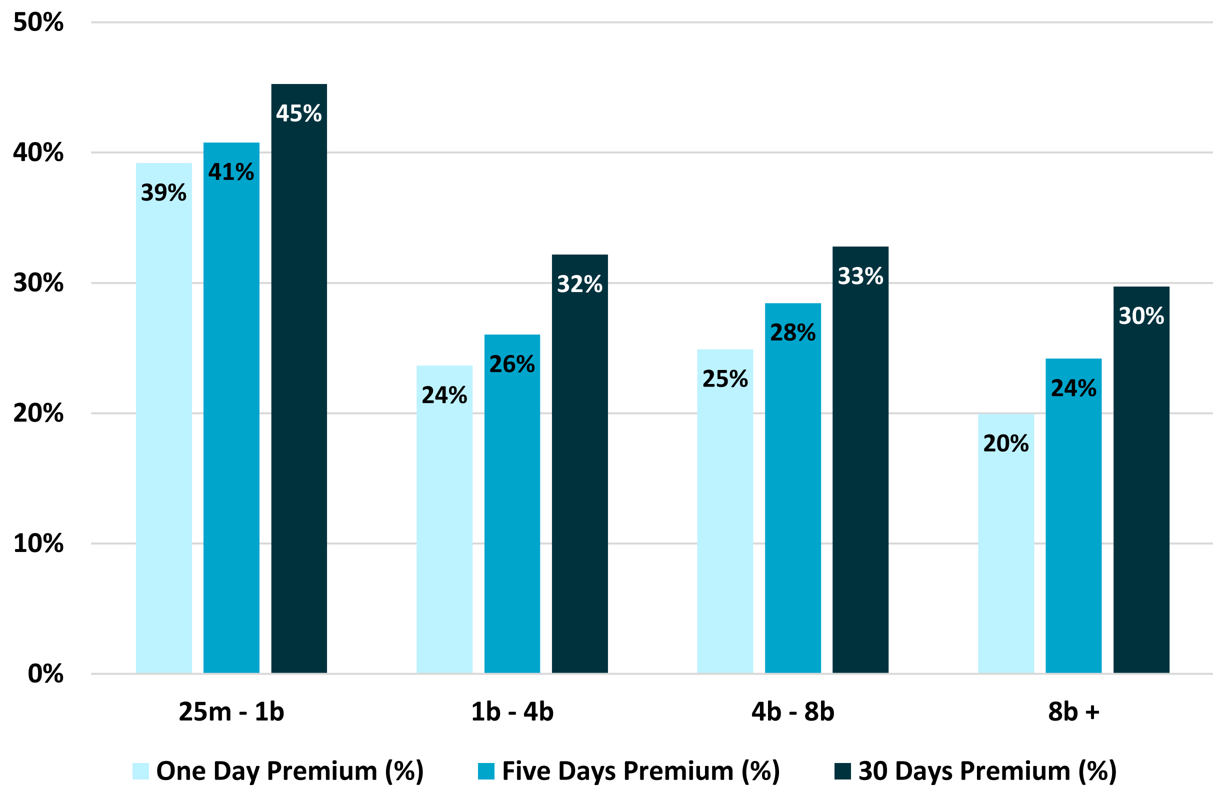
Exhibit 5: Merger/Acquisition Premiums by Target Market Capitalization
10 years ending 12/31/2019



Source: Acuitas, FactSet.

In our view, a significant driver of the increased premium for acquisitions within microcap is the magnitude of the inefficiencies in the space relative to other market cap tiers. Microcap companies tend to have less coverage by the sell side, they tend to be underfollowed and under owned by institutional investors, and ultimately the potential for mispricing is far more likely than it is for larger companies. The greater premiums paid to acquire public microcap companies reflects this tendency for them to be undervalued by the public markets. This is precisely why it is such a lucrative space for active microcap managers to add alpha through stock selection.

The cumulative impact of the increased number of M&A deals along with elevated premiums paid has been significant within the microcap space. Over the past decade, more than one-third of the Russell Microcap Index's entire return has been from companies that were acquired. A key contributor to this dynamic is a simple supply and demand issue: the flood of capital into private equity funds has greatly increased the level

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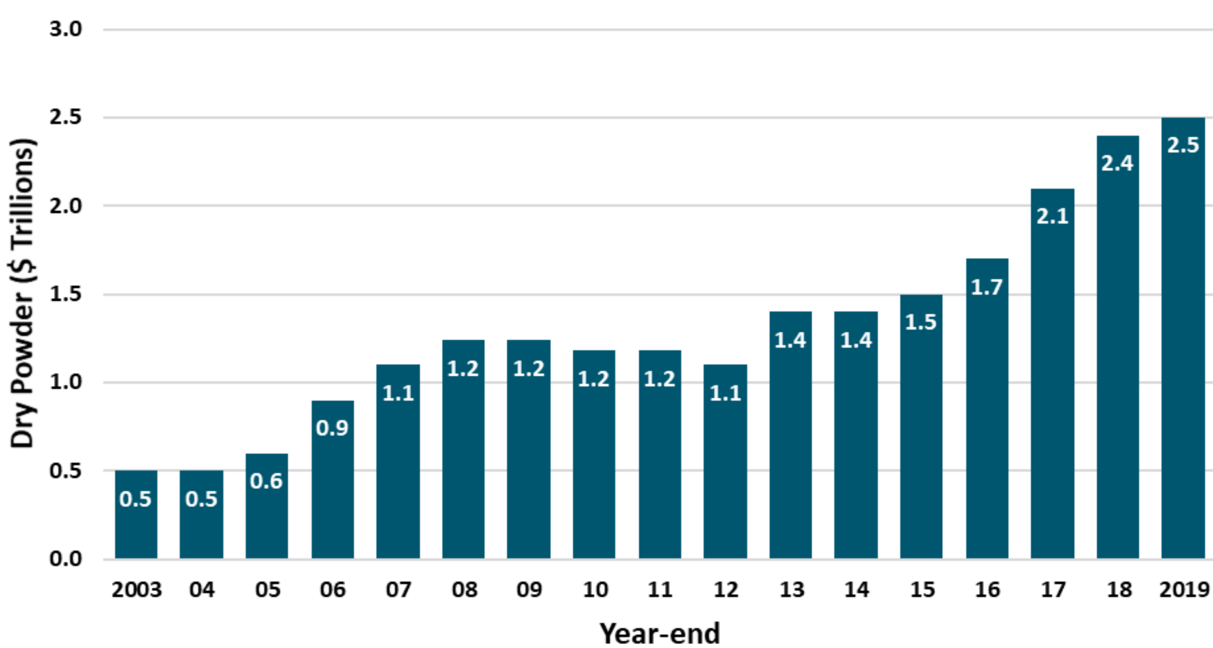
of competition for deals, resulting in higher purchase multiples. We have experienced it directly ourselves, as there have been over 150 takeouts of portfolio companies since the inception of the Acuitas Microcap Composite in 2011. This has translated to roughly 5-7% of our names being acquired each year. Additionally, 2019 was a record year in terms of the number of takeouts across the Composite, and we expect this positive momentum to continue (we expand on this expectation later in this paper). Looking ahead, we feel the mountain of uncalled capital sitting on the sidelines within PE funds is going to continue driving elevated M&A activity at lucrative premiums for shareholders.

Uncalled Capital & Public Microcap vs. Private Equity Multiples

The continued growth in cash piles sitting uninvested in PE funds shows no signs of slowing. This dynamic has been on investors radars for a few years now, as Bain & Company's 2017 Global Private Equity Report highlighted, "Capital superabundance and the tide of recent exits drove dry powder to yet another record high in 2016." Since then, the trend has only continued to accelerate, as allocations continue to flow into PE at record speed. At the end of 2019, global uncalled capital (dry powder) at PE firms hit a record $2.5 trillion, representing an increase of more than $1 trillion in only four years. Exhibit 6 below shows this trend over time.

Exhibit 6: Global Private Uncalled Capital (Dry Powder)
Measured in Trillions of USD



Source: Acuitas, Bain Capital, Preqin

As Exhibit 6 shows, uncalled capital levels were relatively stable between 2007 and 2015. Since then, total uncalled capital has exploded from $1.5 trillion to an eye popping $2.5 trillion. Of course, this data includes funds of all types that fall under the "PE" umbrella. For the purposes of the M&A discussion within public microcap equity, buyout funds are most relevant. At the end of 2019, those funds represented $830 billion of the total $2.5 trillion in dry powder. Amazingly, $830 billion is 63% more than the cumulative market cap of the entire Russell Microcap Index (as of the same 12/31/2019 date). To put it into perspective, every stock within the microcap index could be purchased using existing dry powder at buyout funds, they could pay the average 39% 1-day premium for every transaction, and there would still be $125 billion in uninvested capital left over.

In terms of multiples, Exhibit 7 shows the median EV/EBITDA multiples over the past decade for the Russell Microcap Index alongside the M&A multiples paid by PE firms for public companies. Of particular interest is the correlation between the recent surge in dry powder since 2015 and the elevated entry multiples paid since 2015, which has been quite pronounced. Coming out of the Crisis , M&A multiples paid by PE firms were in-line with public microcap equity valuations. While both have continued to rise over the past decade, the growth in M&A multiples has far outpaced the growth in public microcap multiples, which have been relatively stable. Given the continued momentum in asset raising, we feel that this catalyst for elevated multiples is only going to continue. To be clear, these are multiples paid for public companies by PE firms, since we are comparing them directly to other public microcap companies.

Exhibit 7: Median EV/EBITDA Multiples:
PE M&A Deals vs Russell Microcap Index
10 years ending 12/31/2019

Year	PE M&A EV/EBITDA	Russell Microcap EV/EBITDA
2010	7.7	7.7
2011	10.0	7.8
2012	9.5	7.5
2013	9.4	9.0
2014	10.5	9.2
2015	13.3	9.1
2016	10.5	9.4
2017	12.4	9.9
2018	13.5	9.3
2019	12.6	9.1

Source: Acuitas, FactSet. Data is from M&A deals for the 10 years ending 12/31/2019.

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A sensible and oft-cited reason for the continued rise in M&A multiples is the growth of the technology space, which is a sector that naturally carries higher multiples. This dynamic is only amplified by the extended period of low and decreasing interest rates the global economy has experienced. While there is certainly truth to those statements, the impact of tech (or any sector) on the rising M&A multiples is surprisingly low. According to Bain Capital, only 3% of the growth in multiples from 2011 are attributable to a change in the balance of sectors of the target companies. The other 97% has been driven by intra-sector multiple expansion (i.e. multiples have expanded across sectors, not just tech).

Looking forward, elevated entry multiples for new investments pose challenges for future returns to private equity, as the spread between entry and exit multiples can reasonably be expected to narrow. According to Bain, multiple expansion has accounted for 50% of the returns of buyout funds over the last decade, while revenue growth accounted for just 31%. In our view, the influences of these return drivers will converge as general partners will need to become more successful operators to deliver future returns that match historical and expected returns from allocators. Over the next decade, top line growth, margin expansion, and/or a change in business strategy will become far more important drivers of PE returns than they have been historically.

These challenges that GPs face make many public microcap companies more attractive as potential acquisition targets. Microcap companies often trade at low valuations due to temporary issues that can be fixed with new management directives. Additionally, the simplified nature of many microcap companies (single product/business lines) often amplifies management's ability to directly influence operating results, which will be an increasingly important component of PE returns moving forward. Intuitively it makes sense that cheap companies with fixable issues will be an area of focus for PE funds, and given the amount of dry powder on the sidelines, we feel that M&A within microcap will continue to accelerate.

Active Microcap Avoids Risks Associated with Private Equity

When comparing one asset class to another (microcap vs. private equity), the discussion goes well beyond comparing returns. Assessing risk factors is a critical component of the equation. At a high level, investing in private equity introduces many risks and unique challenges relative to a microcap allocation. Most notable of these are higher fees, a meaningful lack of liquidity, reduced transparency, less flexibility, and restrictive accessibility. All of these issues are well known and are among the primary reasons that cause allocators to demand significant return premiums for private equity investments over public equity. Unfortunately for many PE allocators, those returns haven't materialized. This is especially true when compared to active microcap, as active microcap investors have realized similar returns to PE without any of the headaches listed above. Looking ahead, the flood of capital into private equity, increased deal competition, and elevated entry multiples are diluting forward looking return prospects for private equity.

On the liquidity continuum, public microcap sits somewhere between very liquid large cap stocks and very illiquid private equity investments. Some of the return similarities shared by both PE and microcap could be attributed to the expected liquidity premiums from allocating to the asset classes. That said, U.S. microcap tends to be far more liquid than many investors' pre-conceived notions would imply. Additionally, the liquidity benefit from microcap compared to private equity is significant. Sizeable microcap portfolios can be invested in a matter of days or weeks and without lockups. Conversely, private equity portfolios often take years to get fully invested and can have lockups of up to a decade or more. This clear liquidity advantage allows microcap investors the flexibility to adjust asset allocations over time, raise or allocate capital when needed, and to upgrade their portfolios to keep them invested in their highest conviction ideas. Conversely, despite the meaningful additional risks taken by investors, the returns of private equity have not shown a return premium commensurate with the additional risks over the long run.

Furthermore, most active microcap mandates offer transparency into the underlying portfolios, effectively eliminating the "black box" that exists with many PE funds. This usually includes visibility on all of the holdings, every trade made, daily performance, and the latest risk characteristics. Investors are able to discuss the investment process with the manager and gain insights into when and why managers make portfolio investments, which is not the case with many private equity allocations.

Microcap is a Sensible Choice for Uncalled Capital

A final point to make about the potential value of microcap as a proxy for private equity is the appeal of using active microcap as a placeholder for uncalled capital. There is often a significant lag between the commitment of capital in private equity investments and the time the capital is called. The liquidity of microcap makes it a flexible investment that can serve as a long-term strategic allocation, a short-term proxy for uncalled PE capital, or both. In a 2010 paper on microcap Allianz suggested that (depending on a plan's ability to meet capital calls in the event of a decline) "due to the lengthy vesting period [of private equity], a sensible choice may be to temporarily invest idle, committed but not called capital in a micro-cap strategy." For plans that desire a similar return pattern to private equity with the benefit of greater liquidity, we believe microcap makes a perfect place for uncalled capital. The widespread use and growth of SLCs that we touched on earlier also delays capital calls, making the need for a plan for uncalled capital more important than ever. Additionally, the use of SLCs provides a more consistent and predictable schedule for capital calls along with greater lead time, making the use of microcap much easier from a logistical and operational standpoint for allocators.

Timing

We have passionately been making the case for active U.S. microcap for over a decade, and we firmly believe that microcap as a proxy for private equity is a viable long-term solution. However, for those on the fence we feel that 2021 presents a uniquely compelling opportunity to utilize microcap both broadly and as a private equity alternative. Despite the long-term premium associated with small and microcap, both have underperformed in recent years as large cap growth has dominated the returns of cap-weighted indexes. Even with microcap's fast start in 2021, in our view the relative valuation story for microcap versus the rest of public equity remains compelling.

Additionally – and as touched on earlier – the COVID-19 pandemic caused a notable pause in M&A activity last year. Due to this, we feel there is meaningful pent-up demand for deals to be made. After all, PE firms haven't raised $2.5 trillion in dry powder to leave it uninvested. Exhibit 8 below digs into this pent-up demand a bit more by showing the slowdown in M&A activity as a result of the COVID-19 pandemic. Compared to the most recent five-year period, M&A activity took a meaningful hit in 2020. The table in Exhibit 8 shows the change in deal count by month when comparing 2020 to the previous five years for that same month.

Exhibit 8: Y/Y Change in U.S. Public Company M&A Deals
2020 vs trailing 5-year average

Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
-19%	-47%	-49%	-89%	-79%	-83%	-24%	-35%	-46%	3%	-45%	31%

Source: Acuitas, FactSet.

To put it into perspective, during April, May, and June of 2020, the total number of U.S. public companies targeted in M&A deals fell 83% compared to the most recent five-year average. At some point, the dam will burst and the flood of capital will be unleashed. After this noticeable pause in M&A activity during the peak of the COVID volatility, we have seen an uptick in takeouts across our portfolios in recent months. With multiple approved vaccines providing a light at the end of the tunnel, record levels of cash needing to be placed, and pent-up demand from deals that were shelved during the peak of the COVID crisis, we expect the level of activity to only increase from here.

Additionally, a unique angle is the potential for an increase in capital gains taxes in 2022. President Biden expressed his desire to meaningfully increase capital gains taxes throughout his campaign. Given the success democrats experienced in the Georgia runoff elections, the possibility of passing such legislation is certainly on the radar of many business owners. A unique characteristic shared by numerous microcap companies is a high level of insider ownership relative to larger companies. The potential for meaningful tax savings should provide extra incentive for these insiders to explore a sale in 2021, providing an additional catalyst for M&A to accelerate in the microcap space in the near term. Exhibit 9 below shows the average insider ownership of companies based on the same market cap buckets used throughout this paper.

Exhibit 9: Average Insider Ownership Percentage Based on Market Cap
Russell 3000E Index, as of 12/31/2020

Market Cap Range	Insider Ownership %
25m - 1b	20.2%
1b - 4b	12.4%
4b - 8b	10.6%
8b +	6.4%

Source: Acuitas, FactSet.

Conclusion

We believe that an allocation to active microcap has a place for investors as a proxy for private equity, either as a permanent solution or as a placeholder for uncalled capital. Active microcap managers have generated similar returns and return patterns to private equity but at significantly less risk and costs. Many of the advantages of private equity, such as the ability of skilled managers to generate strong returns through concentrated positions in high confidence investments, can be found with greater liquidity, transparency, and flexibility in active microcap investing. Additionally, there are reasons to believe that it has become increasingly difficult to replicate the private equity returns of the past, including the large amounts of assets that have flown to private equity funds and the difficulty of organizations to build the skills necessary to be successful in private equity investing. Meanwhile, active microcap stocks and managers are positioned to be beneficiaries of the large amount of private equity competing for potential investments. As such, we think for most investors an allocation to active microcap has a better chance of long-term success, with lower fees, and lower levels of risk than private equity.

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