

# A Strategic Case for Investing in U.S. Lower Middle Market Private Equity

## Executive Summary

U.S. lower middle market (LMM) private equity, are typically defined as companies with enterprise values between \$50 million and \$500 million, represents a less-capitalized and compelling opportunity for institutional and high-net-worth investors. As competition in the large and mega buyout private equity sectors continues to intensify with increasing amounts of capital, the LMM stands out for its inefficiencies, attractive entry valuations and consistent value creation. This white paper explores the unique benefits of LMM investments illustrating why this segment is an essential component of a diversified private equity portfolio.

### In this piece, we will cover the following:

- Introduction to the Lower Middle Market
- Why Focus on the Lower Middle Market?
- Structural Advantages for Institutional Investors

## Introduction to the Lower Middle Market

The lower middle market encompasses a broad spectrum of privately held, often founder- or family-owned businesses. These companies are typically agile, focused on stable and growing markets, and spanning diverse industries: including healthcare services, business services, food & consumer, distribution & logistics, and light manufacturing. Vital to the North American economies and employing the majority of workers, LMM companies can often benefit from private equity ownership that unlocks value by: upgrading management teams, implementing stronger financial controls, enhancing sales and marketing functions, and providing both growth and add-on capital. For over 30 years, private equity firms have consistently created value in LMM companies through the full range of value creation levers including: accelerating revenue growth, improving operations, enhancing profit margins, making accretive add-on acquisitions, and expanding the valuation multiple at exit.

Attributes	Parameters
Enterprise Value Range	\$50M - \$500M
Competition for Deals	Moderate
Seller Type	Founder- or family-owned businesses
Operational Infrastructure	Often informal or underdeveloped

## Why Focus on the Lower Middle Market?

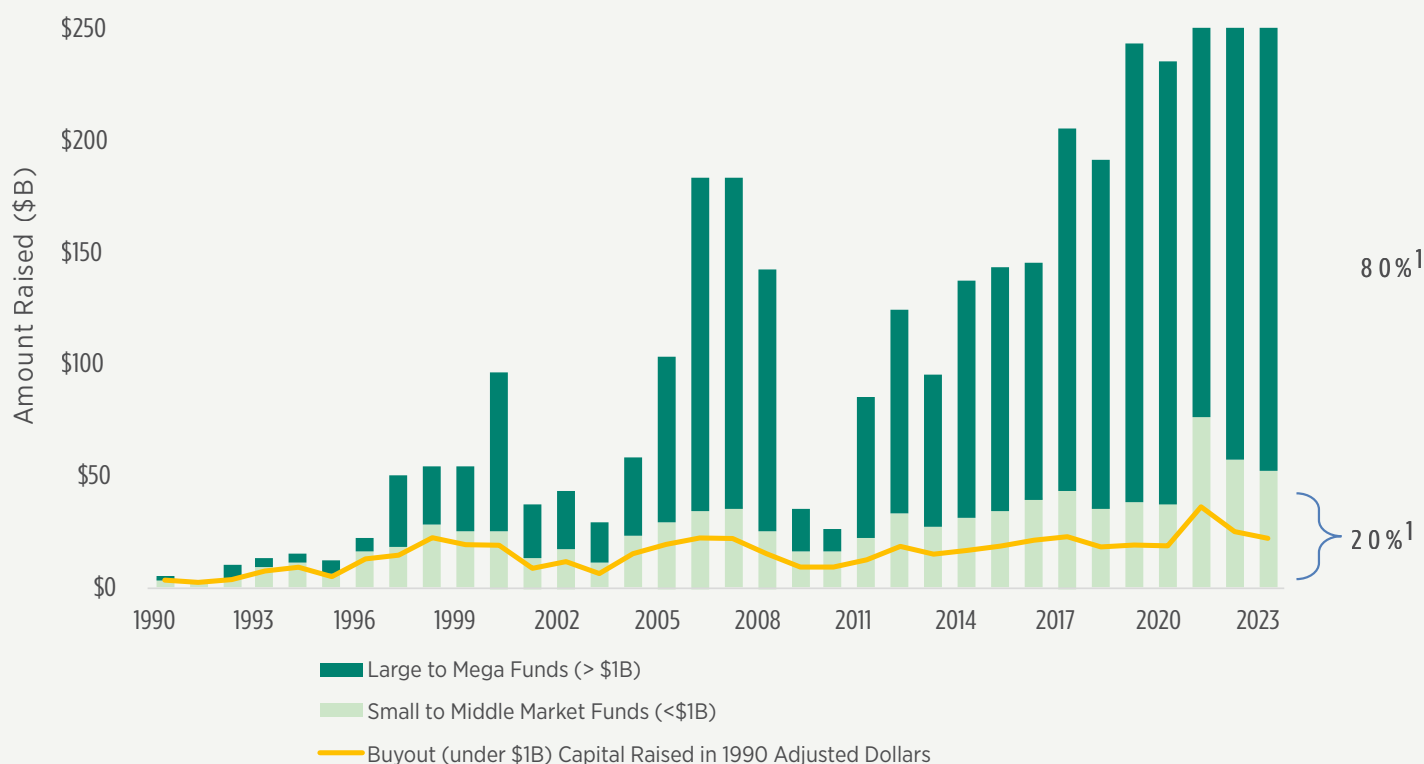
The LMM private equity segment may represent an attractive investment opportunity for many reasons:

### Inefficiencies

One of the primary advantages of the LMM is its inefficiency. These companies tend to be:

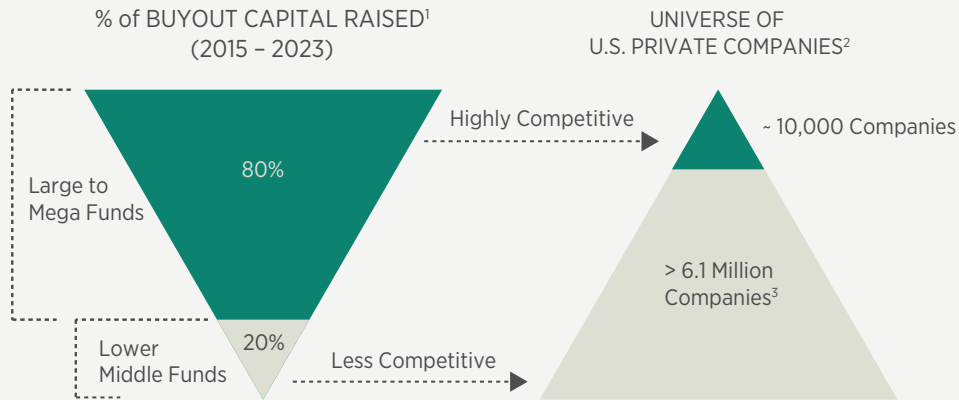
- Undermanaged or lacking sophisticated operational processes and financial controls.
- Priced more attractively with lower entry multiples.
- Less competitive at entry where founders or families often choose a private equity “partner” based on cultural fit and strategic value-add rather than selling out to the absolute highest valuation.
- Operating in a massive market with substantially less capital pursuing it. According to the U.S. Census Bureau, there are roughly 5.7 million U.S. companies with revenues less than \$250 million and only 10,000 companies with revenues above. Large and mega buyout funds structurally can’t invest in LLM companies with less than \$250 million in revenues.

### U.S. Buyout Capital Raised by Fund Size



Source: Pitchbook through 12/31/2023. <sup>1</sup>Approximate Percentages based on capital raised from 2015 to 2023.

## U.S. Lower Middle Markets Historically Have More Opportunity



1. Pitchbook August 2024 Private Equity Buyout, Investor Location United States, Closed Funds.

2. 2020 U.S. Census Bureau (Release Date 3/31/2024.) Businesses are considered large if they have more than 1,000 employees. The data shown excludes ~21 million single-employer small businesses.

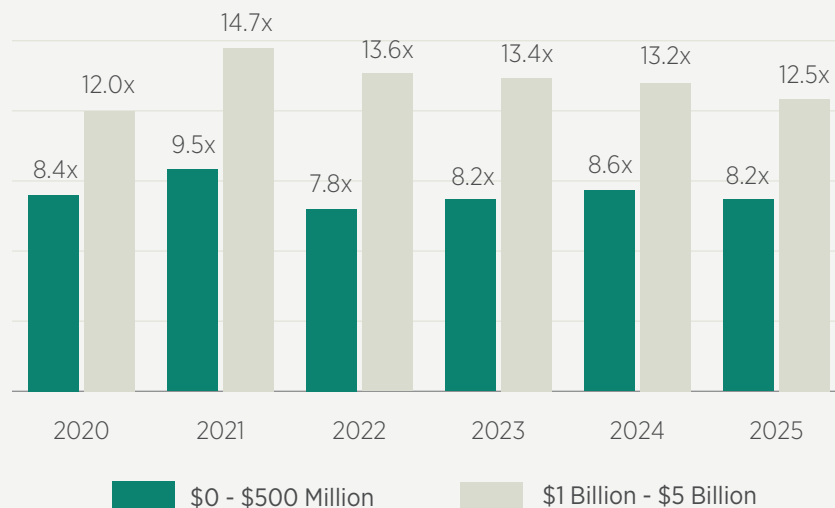
3. Only includes companies with 2 or more employees.

These inefficiencies caused by capital supply and demand imbalances creates opportunities for LMM private equity firms to drive value by: entering at slightly lower multiples, implementing operational improvements, pursuing strategic growth initiatives, and capitalizing on consolidation opportunities.

### Multiple Expansion

In the LMM, entry multiples are typically lower than in the large and mega area. By acquiring businesses at lower valuations, upgrading management teams, driving revenue growth, and enhancing operational efficiencies, private equity firms can unlock meaningful value and achieve higher exit multiples by selling to both strategic buyers or large / mega private equity firms. Larger private equity funds, with significant dry powder to deploy, are often willing to pay higher multiples for companies that have benefited from LMM private equity fund ownership and an upgraded management team. These larger private equity funds are drawn to businesses that demonstrate a proven track record, improved operating models, and strong strategic positioning, attributes that make them highly scalable and poised for accelerated growth.

### EV/EBITDA Multiple by Enterprise Value



Source: Pitchbook – Q2 Global M&A Report

## Fragmentation and Roll-Up Opportunities

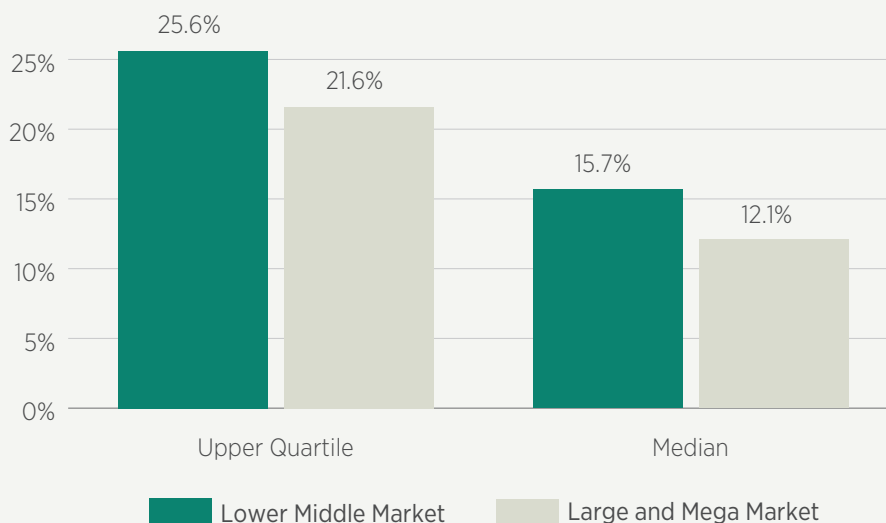
Many industries in the LMM are highly fragmented, creating opportunities for “roll-ups” or “buy-and-build” strategies. By acquiring and consolidating smaller operators at lower valuations, private equity sponsors can build larger, more competitive platforms that ultimately command a premium valuation at exit. Sectors such as collision repair, HVAC, and veterinary services have already demonstrated the success of this model where regional players scale into national market leaders through disciplined consolidation.

## Historical Performance

U.S. lower middle market private equity funds have consistently outperformed large and mega funds on a net IRR basis, as illustrated in the chart below. In addition to more substantial absolute returns, the LMM has demonstrated consistency across vintage years with lower loss rates than early-stage venture capital or emerging strategies.

### Lower Middle Market IRRs Have Outpaced Large-Cap

Vintage: 2000 - 2004



Source: CEPRES. Lower Middle Market includes funds <\$1 billion. Large and Mega Market includes funds >\$1 billion

## Demographic Tailwinds

**A wave of retiring baby boomer founders and families are accelerating deal flow in the LMM.**

- 75% of private companies in the U.S. are expected to transition ownership over the next decade.
- Many owners are seeking liquidity but want to preserve company culture, creating strong alignment with values-driven private equity sponsors.

## Inherent Advantages for Institutional Investors

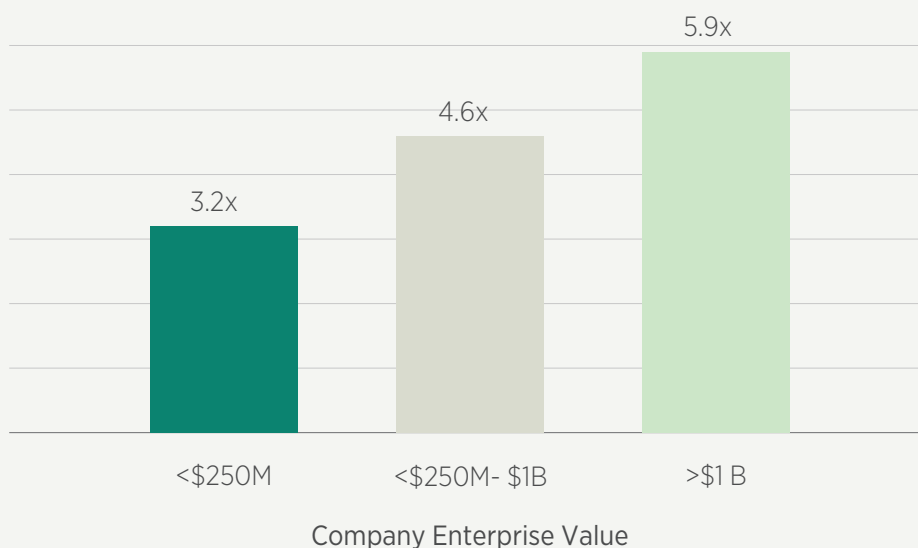
### Downside Protection

Many LMM transactions involve majority control, giving private equity managers the ability to install experienced management teams, optimize capital structures, and enforce operational discipline—all critical levers for mitigating downside risk.

### Lower Leverage Multiples

Companies valued under \$250 million typically use less acquisition leverage than larger companies, reducing both interest expense and overall risk. This more conservative capital structure also frees up capital to reinvest in growth or distribute to shareholders. In addition, LMM companies also often rely on a single lender rather than large syndicates typical for bigger LBO's, making it easier to navigate debt negotiations and resolve occasional softer business periods.

### Average Leverage Multiple (acquisition years 2000-2020)



Source: JP Morgan, Pitchbook

### Active Value Creation

Unlike passive investment strategies, LMM private equity firms take a hands-on approach to value creation. Managers often upgrade management teams, implement more rigorous strategic planning, improve salesforce execution, drive digital transformation, and pursue margin enhancement initiatives, this proactive engagement positions portfolio companies for sustainable growth and long-term profitability.

### Lower Correlation with Public Markets

Given their niche market focus, LMM companies are often less exposed to macroeconomic shocks and exhibit lower correlation with broader public equity markets. This makes LMM investments particularly attractive for investors seeking diversification away from public market volatility.

## Investor Considerations and Risks

While the LMM may offer compelling return potential, investors should carefully weigh certain risks. These include: illiquidity, as investments generally require more extended hold periods, heightened manager selection risk due to greater performance dispersion across LMM funds, and operational challenges inherent to smaller businesses, such as key-person dependency and scalability constraints.

## Role of LMM in a Diversified Portfolio

Allocating 5%–15% of a private investment portfolio to LMM private equity may deliver meaningful diversification benefits, enhanced return potential, and exposure to economic growth at the grassroots level. Incorporating LMM investments into a broader portfolio can reduce an investor's reliance on large scale buyouts and public equities, while accessing untapped sources of growth.

## ESG and Impact Investing Potential

The LMM also presents a unique opportunity for investors looking to align their capital with Environmental, Social, and Governance (ESG) principles. Private equity sponsors can actively influence businesses to promote diversity in leadership, drive sustainability in overlooked industries, and create jobs in local communities.

## Risk & Mitigation Strategies

Risk	Description	Mitigation Consideration
<b>Illiquidity</b>	Long hold periods (5–10 years)	Align with long-term capital or closed-end fund structures.
<b>Founder Reliance</b>	Key-person or succession risk	Leveraging LMM firms to upgrade and build out management teams
<b>Underperformance Dispersion</b>	More variability between top and bottom quartile funds	Rigorous manager selection and co-investment rights
<b>Less Data &amp; Reporting</b>	Less rigorous systems & financial controls at entry	Early investment in systems and reporting

## Conclusion

As competition in large and mega private equity intensifies, the U.S. lower middle market remains relatively undersaturated and less efficient. This allows agile and disciplined investors to capitalize on the most persistent sources of alpha: value creation, multiple expansion, and strategic exits.

In Summary:

- The LMM may offer strong risk-adjusted returns with lower entry multiples.
- It enables hands-on value creation and strategic roll-ups.
- It benefits from succession-driven deal flow and demographic tailwinds.
- It provides portfolio diversification and ESG alignment.

Now may be a compelling time for institutional and sophisticated investors to deploy capital into this attractive alternatives segment.

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