Episode 90

FireSide: The middle market—Beyond the limit of public equities

The publicly traded index tracks similarly sized companies. What can it tell us about potential opportunities in middle market private equity?

Lara Rhame (00:05):

Welcome back to FireSide, a podcast from FS Investments. I'm Lara Rhame, Chief U.S. Economist, and I'm excited for today's podcast because here at FS Investments, we spend a lot of time thinking about the middle market. A large swath of our alternative strategies is hitched to this powerful engine of growth in the U.S. economy. But increasingly, I get the question, how can we be bullish on the middle market when the Russell 2000, which, is the publicly traded index that includes similarly sized small- and mid-cap firms, chronically underperforms? And as so often happens, I get asked a question, I turn around, I ask Andrew, and he responds with a thoughtful, informative, and incredibly clear piece of research that blows me away every time.

So today I wanted to walk through that work and the answer. And Andrew, I feel like you barely need an introduction. We've been podcasting a lot recently, which has been great for everybody. But—Andrew Korz is an Executive Director on our Research team. He's a thought leader on commercial real estate, private debt, and for many years, now equities.

So, Andrew, welcome.

Andrew Korz (01:24):

Hey, Lara. It's great to be here. I think this is a really interesting topic that hasn't been discussed a ton. So, I'm excited for the discussion.

Lara Rhame (01:32):

Yeah, and I thought the answer would be shorter or rather one dimensional—it's got many dimensions to it. That's the better way to say it.

I'm going to just zoom out a little bit and ask why we're talking about this. Obviously, the S&P 500 is the traditional asset bellwether. You know, April notwithstanding, right, it's performed really well over the years. Even today, it's up, you know, five and a half percent year to date.

And I think we know the challenge. I know we're going to go into detail on that a little bit more, but even with this correction in April (not even technically a correction, I guess, but "downtick"), we're still trading at expensive, over 20X price-earnings ratio. Why would we want to do a whole podcast on the Russell 2000?

Andrew Korz (02:18):

It's a great question. And to your point, that part of the market, that small and mid-cap part of the public markets has really underperformed for the better part of the last decade really coming out of covid. We did have that sort of boom, if you'll remember, as we sort of rebounded.

Lara Rhame (02:34):

But if you blinked, you missed it. That

Andrew Korz (02:35):

Outperformance, once you missed it, to your point, it was powerful. But by the end of 2021, it was kind of all used up. And actually really over the past three years, it's underperformed the S&P 500 by close to 40 percentage points. It's incredible, just a massive underperformance. And there's lots of reasons for that that I think we're going to get into. But ultimately what I think it's done is it's further entrenched this narrative that the only game in town is the S&P 500, and specifically some of the mega cap names that we all know and mostly love, and which have kind of garnered most of the value that's accrued from this AI narrative. But I think if we dig a little deeper, what you kind of see is that this underperformance doesn't have as much to say about the strength of the US economy, the attractiveness of the US middle market as it does about the unique composition of the public markets, and really what has happened to public markets over the past couple of decades.

Lara Rhame (03:27):

Well, and this is an issue because it's not just that the Russell 2000 has underperformed, the fundamentals are bad. And I think that is something that I want to pull out because often these smaller companies are known to be an engine of growth, and we all know that. I mean, except for the Mag seven, when companies are in their earlier stages or when they're smaller, is often when they grow so fast. And we love as investors to participate in that growth. So when I think about the fact that for decades, the Russell 2000 often recovered faster in the beginning of an economic cycle, all these characteristics that make it good and then layer on the fact that when something's underperformed for years, you kind of naturally start to think, Hey, maybe that's where value is. But today, the fundamentals of the Russell 2000 are so bad, what's happening with these companies? What was the statistic that 45% of companies in the Russell 2000 have negative earnings? How's that possible when the economy's doing well and the earnings in the S&P 500 are so strong?

Andrew Korz (04:37):

Yeah, no, and just take a step back, you think about why people have historically invested in small and mid caps. To your point, I mean financial sort of theory, the Fama French model would tell you there's an excess premium to be had in investing in smaller companies. To your point, these companies tend to be younger, faster growing historically, they tend to be maybe more cyclical, and as a result, they tend to outperform early in an economic cycle as rates are rising, et cetera. But there's been this trend over the past couple of decades, and it's for a bunch of very concrete reasons where the quality of the public, small and mid cap market has really deteriorated.

Lara Rhame (05:16):

And I want to highlight that the quality of the public small and middle cap, absolutely, because we're going to talk about private markets in a second, but Anders really walking us through this public side of the market.

Andrew Korz (05:27):

And to me, the Russell 2000 is less reflective of the breadth of us mid-sized companies than it is a proxy for what has gone on in capital markets in the US over the past couple of decades. So to your point, I mean, 25 years ago in the late nineties, only 15% of companies in the Russell 2000 had negative earnings. Today it's more than 40%. If you look at margins, OFID cap companies in the public markets against the S&P 500, the S&P 500 has almost doubled its free cashflow margin. Over the past 10 to 15 years. The mid cap market hasn't increased its margin at all. So it hasn't really benefited from any of these secular trends, globalization, falling, interest rates, et cetera, that we've seen in other parts of the market. And ultimately what has happened is that the type of company that has gone public over the past two decades has really changed the growth of the private markets, has given companies an option to stay private for longer.

(06:28):

And ultimately what we've seen, I think is a hollowing out of the public US equity market. And because of the dominance of the large caps and of the mega caps that we've seen, I think people are kind of missing that. But what you really have now is this barbell in the US public equity market, where you take the Russell 3000, which is basically the 3000, most of the public market, 98% of the market capital, the public markets, the top 50 companies combined are larger than the next 2,950. So you sort of have this ultra high quality, high end of the market, and then the rest has been, you have this long tail of largely lower quality firms. Now, to be clear, there's absolutely some opportunity to be had in the public markets here, but by and large, what you've seen is a hollowing out of the public markets. And the other sort of side of that has been the growth of the private market.

Lara Rhame (07:21):

Well, and I think just to put a bow on that last point, even if you're trying to at that point, cherry pick good value within the publicly traded small to mid cap space, that's active management. I think that's the key issue here, which is that when we think about the option between traditional more passive investments, the Russell two thousands really failed. And this I think comes to the point, which is that it's a horrible mirror of the private middle market. And that is something that I think is so critical because the US economy today is, I would argue strong, and I know I would agree. And when we think about this really big engine of growth, just talk to me about the size of the middle market, outside of the public sphere, just from the economy, our GDP $25 trillion, let's call it. How big is that middle market?

Andrew Korz (08:24):

Yeah, I mean, so you're talking about estimates of when we're talking about the middle market, generally people have different sort of definitions for it, but you're generally talking about a company with an enterprise value anywhere from like 25 million to a billion dollars. I think as the economy has grown, we will probably consider some larger companies middle market, but you're talking about more than 200,000 companies in the US that sort of fit into that box. You're

Lara Rhame (08:51):

Talking 200,000 versus this little tiny B place in the Russell 2000.

Andrew Korz (08:56):

It's highly fragmented, lots of different industries dispersed across a wide variety of economic sectors. You're talking about a third of us private sector, GDP, more than 50 million people in terms of employment. So just a massive opportunity, and I don't have an exact number, but 95% plus of that opportunity is located not in public markets, but in private markets. Yeah.

Lara Rhame (09:18):

Alright. So this drives me to one of my big conclusions, which is access. And we have talked a lot about this cycle that has kicked in where as companies have stayed private longer, more investors have flowed to those companies. I mean, you put it perfectly, what did you say? Go where the S are?

Andrew Korz (09:43):

Yeah, go where the companies are, go where the opportunity is, where the growth go, Lara Rhame (09:46):

Where the growth is. So many investment dollars have flowed to this in a variety of different deal shapes and sizes and constructions to investing in these private middle market companies with really phenomenal returns. Talk to us about the fundamentals in the private middle market.

Andrew Korz (10:09):

So first I do want to step back and just talk about very specifically why the public market isn't reflective of what we're talking about here. Good, good, good. So we've talked about the lower quality, we've talked about the types of companies, 42, 40 5% of Russell 2000 companies with zero or negative earnings. Why is that? So I think what's happened, as I've mentioned, I'm glad you

Lara Rhame (10:29):

Brought this up because the answer really surprised me. I didn't

Andrew Korz (10:31):

Understand this. You think about companies going public and historically they've gone public because they've gotten large and they've wanted to access larger pools of capital from public investors. And as time has gone on, it's become more and more possible for those larger companies to stay private for longer. So what's ended up happening is those companies, because staying private is attractive in a lot of ways, going public is expensive. You have disclosure costs and regulatory costs, and you have to answer to shareholders every quarter and show results. You sort of lose control of the narrative. All these things sort of point towards staying private if you can. And more and more that's become possible. You can, yeah. So when you think about why the public market has become lower quality, think about the types of companies that have gone public. The types of companies that have gone public are increasingly, I think over the 2010s it grew to 60 plus percent of the annual IPO volume was from VC-backed companies. And you can sort of track the growth in a similar fashion of the percentage of IPOs that were in tech and biotech and pharma, these sort of boom bust, ultra high growth, ultra risky parts of the market. Because you think about what's the business model of a venture capital firm? They pick a bunch of different companies, they give them money, and the hope is that five 8% of them hit and it pays for all the losers.

Lara Rhame (11:55):

It's the lottery model. Yeah,

Andrew Korz (11:56):

Exactly. So N VC has sort of used the IPO market as sort of their vehicle for exit liquidity, right? So the types of companies that have gone public have really started to gear towards VC backed tech, pharma, biotech, low earnings, high growth type of companies with lots of risk, and they're boom bust, right? So you think about that, like a company that goes public, if it booms, if let's say a biotech firm, it's drug passes stage three clinical trials, stock goes up 300%, it's out of the SID cap market very quickly, right? Where if it busts, it sort of lingers in the market there. So you've got

Lara Rhame (12:35):

With terrible fundamentals, right?

Andrew Korz (12:37):

Right, absolutely. And with high volatility, et cetera. So these are the, and to be clear, we're besmirching the VC model. That's not the goal of this podcast. No. For every firm that doesn't work out. There's an Uber, there's a Facebook, there's an Airbnb, et cetera. No,

Lara Rhame (12:51):

It's an incredibly important part of what makes the US economy so vibrant and dynamic. It's just important to recognize that this model has become so entrenched and almost synonymous with the Russell 2000

Andrew Korz (13:04):

Index. And it's less about an increasing sort of issue with VC-backed companies going public. It's that nobody else is going public. It's that the rest of those companies sort of your regular way, whether it's industrials, whether it's consumer, all these types of companies that may have gone public 20, 30 years ago are deciding to stay private longer now. So the other issue then is that companies are going public. The ones that do are going public later, so they're older. A lot of that growth has, or more of that growth has already been accrued to private investors so that by the time they go public, there's less juice to squeeze per se. So I think all of that's to say the public market is again, increasingly less a proxy of the core US middle market and more a proxy of what has gone on and the mega trends in US capital markets over the past couple of decades.

Lara Rhame (13:54):

And we talked about how over 40% of Russell 2000 has negative earnings middle market, the numbers way smaller,

Andrew Korz (14:01):

Way lower. Yeah. I mean, we have a chart in this chart book that shows that if you just take 2023 revenue growth, US economy grew, what was it? 3.1% real 6% nominal. So really strong nominal and real growth. Only 8% of broad middle market public and private firms saw revenues decline 8% in the public markets. It was a third 33%. So we're painting a picture of just two markets that don't look like each other at all. The types of companies don't look like each other. And ultimately, I think if you're looking to gain access to that really strong part of the US economy right now and sort of align yourself there, you really can't do it in the public markets right now.

Lara Rhame (14:44):

I think something that comes up, and this is almost a side issue, but I do think it's really important to this discussion, is talking about ways to mitigate international geopolitical uncertainty. And something that I like to bring up, again, a question I get asked a lot is, are markets really pricing in geopolitical risk? And I feel like I get more concerned than the average investor about the fact that the S&P 500 really is concentrated in these large global companies that get 50% of their revenue from abroad at a time when the developed world is experiencing weak growth. China's experiencing very weak growth and there's geopolitical uncertainty. When I look at the US economy, we kind of forget that unlike the S&P 500, the US economy is actually much more closed. Our economy only has call it 15% of our GDP coming from abroad versus the market which is much more international.

(15:51):

But US middle market companies are more insulated from this geopolitical uncertainty. And I want to bring that up because I do think that over my career, it has not always been the answer to double down on the US economy. But I do think that today that is a very viable strategy if you're looking for growth. And again, the problem is it is easy to think of looking to these publicly traded vehicles like the Russell 2000 to find that growth at a better valuation. And today, that's just not the reality. And I think that's the access point that I want to drive home. There is a way to get access to this growth that not only is strong, but is perhaps more isolated from global uncertainty through the middle market, the private middle

Andrew Korz (16:41):

Market. And I think if you look at the S&P 540% of revenues come from abroad in the Russell 2000, it's only 20%. So 80% come from the us, but it hasn't helped the, so if you look at the US economy since the end of 21, it's grown 15% in nominal terms, S&P 500 earnings are up about 15% Russell 2000 earnings are down. So it hasn't harvested that strong growth in the US economy. The broad middle market, again, 80 or 85% come from the us, but it has harvested that growth, right? You've seen consistent 12 percent-ish annual revenue growth in that part of the market. So again, there is an opportunity to harness this growth. There are a ton of companies out there that are doing really well and are able to fight through this, increase in some uncertainty, increase in interest rates, et cetera. It's just a question to your point of how do you access it.

Lara Rhame (17:33):

So let's go back to that private equity space because we have these now sort of mega funds, the Blackstones of the world, and I'm not just saying this because I'm five feet tall. I'd like to think that smaller can be better. How do we think about accessing that middle market outside of just these juggernauts that I feel like now that's what people think of when they think of private equity, but it's such a more diverse space.

Andrew Korz (18:04):

And what we've seen over the past couple years is that deal volumes, m and a volumes have been challenged. And a big so spot for that has been the mega cap funds, which are predicated on doing these huge deals. They're much more exposed to broad m and a trends than is the smaller companies. So we think of the middle market as the sweet spot. You have PE for smaller companies, those companies tend to be a lot riskier. And then there's again, the mega cap buyout, large cap PE funds, which in a lot of cases the juice has been squeezed there and there's not as much opportunity to drive operational efficiencies to drive technological improvements. Those companies in a lot of cases have already sort of exhausted those opportunities. So we think in the middle market as sort of that sweet spot where these companies are still small enough to where you can really add value as a talented private equity firm, but they're also large enough where you're not dealing with management that has no idea what they're doing.

(18:58):

Generally, sometimes maybe, but right, clearly. So I think the other thing is when you think about these larger cap, they're much more reliant on higher leverage, getting debt and sort of levering these companies up and much more reliant on valuation exiting at a higher multiple than they invested in. And a lot of that's predicated on what's going on in the public markets. The middle market is more geared towards, again, operational improvements, improvements in revenues, expanding margins. About 70% of the average capital multiple in a middle market buyout transaction comes from revenue growth and from margin expansion. Right? So you're talking about the

Lara Rhame (19:38):

Growth.

Andrew Korz (19:40):

Yes. You're talking about a more sustainable, I think, and less volatile way of adding value and of seeking returns. And the other thing I would say is what we've seen is transaction volume has been more consistent in this part of the market. So you haven't seen these big swings up and down in terms of the ability to get deal flow because there's more exit opportunities you can sell to one of these large cap funds, you can do a trade sale, a strategic acquisition. Some of these companies may go public. There's more sort of arrows in the quiver in terms of exit liquidity for, I

Lara Rhame (20:12):

Think that's a really important point too, because I think we think about private equity investing is you're a billionaire and you lock money away for 15 years. I think today it's really important to recognize that there are ways to access the middle market through strategies that give you more regular liquidity than just, and that I think that breadth of exit opportunity is a piece of that story.

Andrew Korz (20:36):

You think about matching strategy with structure, I think it's important that you do get consistent liquidity within the fund to be able, to your point, retail investors are increasingly accessing this market through evergreen funds, which do offer sort of periodic liquidity. So it's important that structure and strategy sort of meet there. But ultimately I think this market is highly fragmented. We talked about 200,000 plus companies in this part of the market, and you need to get the right managers. There's a ton of managers, there's a ton of companies, there's a lot of fragmentation, there's good managers, there's bad managers. Accessing this part of the market requires a lot of expertise and a lot of precision and relationships importantly. But ultimately, if you can do it right, and the numbers show it, if you look at returns over the long term middle market, private equity has well outperformed public markets, especially the Russell 2000. And it's outperformed the mega cap buyout, the large cap buyout funds as well. So it's really attractive. There's more dispersion because there's more fragmentation. But again, if you can do it right, it tends to be very compelling.

Lara Rhame (21:41):

Alright, thank you so much for that incredible discussion and dive into this topic. I think the key takeaways that I just want to hammer again are the fact that the Russell 2000 is a terrible mirror of the robust, strong fundamentals and growth that you find in the much broader US middle market. And that access is really something that we just don't think enough about and that there's a lot of middle ground between overnight liquidity in the Russell 2000 and a 15 year lockup in private equity. There's a lot of room there, I think to incorporate these strategies into your portfolio. Andrew just wrote this great piece. I think it's phenomenal education on this topic. FS investments.com, look at our insights page. It's there. And thank you so much, Andrew. This was really fantastic. Yeah,

Andrew Korz (22:36):

Thanks Lara. That was fun.

Lara Rhame (22:39):

This episode was recorded at the FS investments headquarters in Philadelphia's historic Navy yard. It was produced by the investment research team, edited and engineered by Erin Sherman video, produced by Melissa Venditti and copy provided by Harrison Beck. Special thanks to show coordinators Ellie Zang and Lara Coleman. Thanks for listening.