FS INVESTMENTS®

Episode 94

FireSide: Middle market private equity—Greed versus fear

As sky-high valuations continue to define public markets, investors turn to middle market private equity to seek a better balance of greed and fear.

Lara Rhame (00:05):

Welcome back to Fireside, a podcast from FS Investments. I'm Lara Rhame, chief US Economist here at fs, and today we're going to talk about a topic as old as investing, which is balancing greed and fear, specifically against the backdrop of sky high public equity valuations and a market that is placing no weight on any risks, or I guess that's kind of another way to say fear. In other words, the levers hard over on the greed side of that spectrum. Our discussion today will be on how to bring a better mix and a better balance to this spectrum by investing in middle market private equity. And I'm joined by two new faces on the FS Fireside podcast. Certainly not new to the firm. The first one is Madison Murphy, who works with me on the research and fund communications team, and has been at FS Investments for three years now. She focuses on private equity, multi-strategy, liquid alternatives. Madison, welcome.

Madison Murphy (01:12):

Thank you, Lara. Yeah, thanks for having me on Fireside, very privileged to be invited on.

Lara Rhame (01:18):

This is going to be great. My other guest is Phil O'Brien, who I have also had the pleasure of working with for four years now. Phil is a member of our client portfolio management team, and he specializes in global asset allocation and private equity. Phil, welcome. Well,

Phil O'Brien (01:34):

Thanks for having us. Good to see you. Good to be here.

Lara Rhame (01:36):

I think Phil, you're in person with us here in our home office in Philadelphia, but you live in Chicago, and I know that you're almost constantly on the road. And something that I think is really important for everyone to know is that you've really spent decades helping advisors and investors understand markets. So I think your perspective and how you're taking these investment strategies and opportunities to your discussions is going to be really valuable.

Phil O'Brien (02:04):

Oh, thank you. It's a pleasure. I really enjoy it.

Lara Rhame (02:06):

So why are we here today? I'm actually going to keep this really simple. Phil, tell us greed versus fear. We are hard over on the greed side of that spectrum. How do we get to such an extreme place in market pricings and valuations?

Phil O'Brien (02:21):

I think that's an excellent question. I don't think people look back far enough to understand where they are. But here, here's the thing. If you look back at the last 10 years of low rates and you look at globalization and the rise of big tech, you put all those together, and today the markets are very skewed. They're just like a way we haven't seen them before because tech margins have climbed while the rest of the market has remained stagnant. I mean, just for example, if I look at tech and software, their 25% EBIT margins compared to the rest of the S&P at 15.

Lara Rhame (02:52):

Yeah, it's extraordinary.

Phil O'Brien (02:53):

Yeah, it is. It's unprecedented. So this free cashflow margin is unprecedented. People compare to big tech, but it's different. It's so different than just going back to the late 1990s, for example. If I have free cash on margins of 30 and they're compounding that at 20 and they're returning it in buybacks on dividends, I mean the wall to jump for the rest of the world to catch up with that and just to work with that is, it's crazy. It's something we haven't seen. So if I look at that mag seven and I add together Berkshire, JP, Morgan, Broadcom, that gives us 40% of the risk of the s and p. Yeah, 40% of the risk.

Lara Rhame (03:34):

That concentration is what, 40, 45 year highs. But it's really something we just haven't seen.

Phil O'Brien (03:40):

But here's the thing. I think the last thing I point out is this is not just a US phenomenon. I mean, you're seeing this concentration in Europe and emerging markets around companies that have this big cashflow. They have stability and they have the ability to spend and sustain margins. So with a long time getting here, we're here, it's different.

Lara Rhame (04:03):

Yeah, it's absolutely different. And I think while so many investors have enjoyed the ride of the s and p 500, when we talk about there being a lot of greed, I mean, greed is not bad. Greed can be good. We all want growth. We all want, the reason that we're investing is to get those gains. But I think Madison, the work that you did, and here I'm going to plug a blog that you wrote with Beth Ann opine, one of our colleagues about the diversification dilemma. I think you really put statistics around fomo, the fear of missing out. I love that you added another one. FOMM

Madison Murphy (04:40):

FOMM. Yeah.

Lara Rhame (04:43):

Fear of missing momentum. Right. I think you really have proven, it's not just me saying that there's fear of missing out. There is empirical objective observation that FOMO is at peak.

Madison Murphy (04:57):

Yeah, absolutely. Yeah. And we're speaking about greed and markets. I think this FOMO mentality is exactly where we're seeing this play out. We're seeing as markets dip down, investors are piling into buy the dip. So you're really seeing this extreme upside volatility in equity pricing right now. Usually you'd expect volatility to be more dramatic on the downside than the upside, as equities gap low and solely grind higher. But right now, upside volatility is actually two times more extreme than downside. We haven't seen this kind of dislocation since 2002, so over 10 years. And really what this means is it's creating this potentially false sense of security for investors, which is a critical piece to this.

Lara Rhame (05:44):

Yeah, that's the piece that there's no fear. It's just like not only is everyone enjoying the ride, but they just think it'll never stop. And I think what to me is that complacency is something that I'm working so hard to dispel, and I think we're working so hard to dispel in our conversation

Madison Murphy (06:00):

Completely. There's a lack of, you're

Phil O'Brien (06:01):

Right, you need to call it out.

Madison Murphy (06:03):

Yeah, yeah. There's a lack of regard for downside protection or diversification away from equity beta.

Phil O'Brien (06:09):

And I think the point you point out, I mean, this hasn't happened since the tech bubble, right?

Madison Murphy (06:13):

Yeah. Yep.

Phil O'Brien (06:14):

So it's one swap. Maybe my mouth is failing me today, but once every 25 years, you see something like this, right?

Lara Rhame (06:21):

Yeah, right.

Madison Murphy (06:23):

So

Phil O'Brien (06:23):

Unusual

Lara Rhame (06:24):

For the other 24 years. I know.

Madison Murphy (06:27):

Exactly, exactly. But there's this real fear of a scenario where we see a market melt up like the nineties when 1999 markets returned 21%, and then the subsequent three years we saw returns of negative nine, negative 12 and negative 22%. So investors just need to be prepared for a market. They can't underestimate the risk,

Lara Rhame (06:49):

Right? Yep. Yep. That's well said. So s and p has worked out well. I think we know a lot that there are problems with this. There's the high concentration, there's the high valuations, and then you're adding this third leg of the stool, which is complacency. And I think that's measurable. It's observable, and it's also, again, a real issue for that investment. We want to talk today about private investments, and I think that first discussion, that first path is public versus private. And Madison, I'm going to pitch it back to you because we talk about private markets, unlike the public counterpart, private markets have not had this smooth ride over the last couple of years. So talk to me about the state of the market today and where we look right now.

Madison Murphy (07:47):

Sure, yeah, absolutely. And

Lara Rhame (07:49):

Maybe that little history.

Madison Murphy (07:50):

Yeah, yeah, absolutely. So I mean, we've all seen the headlines that m and a activity has been suppressed by the fed's unprecedented rate hike cycle, 500 basis points in 18 months. And what that means is there's been a lot of bad press for the private equity market, and it has been stalled in 2023. We saw transactions down 17% from the year prior, and down 25% from the peak in 21 we saw fundraising down. We've also seen exits down, meaning limited liquidity for investors. So markets are definitely stalled right now. But I'd say that there are kind of two main takeaways from that.

Lara Rhame (08:30):

They're not frozen. They're

Madison Murphy (08:31):

Not frozen by any means. They're not frozen distinction. Exactly. Exactly. And so there are really two main takeaways from that. One, when you're looking at 2023 and the current environment that we're in for private markets, you have to look at it through a historical lens. And when you do that, you realize it's not as bad as the headlines are making it out to be. And then the second part of that would be middle market has fared much better these headwinds. So just kind of hitting on the first point, 2021 was a historic year for transactions and fundraising and euphoric deal making, but 2023, it was still the third best year for overall transaction flow in private equities history. So deal flow also is roughly in line with pre covid levels. So really you have to kind of keep that perspective in your mind, Phil,

Lara Rhame (09:21):

When you're talking with advisors, when you're in offices, when you're really, I think having these discussions, what is this sense around private market in general? Are people wary? Do they feel like there's another shoe to drop because of higher interest rates? What's the story from the road?

Phil O'Brien (09:41):

I mean, I think two things. First of all, I think just the speed of which the world is coming around us right now, there's a lack of awareness. I mean, we're talking about perspective. So one thing I point out, this is a different world we're living in today. If I look back to just as a quick example, two thirds of returns of buyout deals entered into between 2010 and 2021 were attributed the multiple expansion, two thirds of that was leverage. And now, so low

Lara Rhame (10:09):

Interest rates. Yeah,

Phil O'Brien (10:10):

I mean it's the same thing. We're talking about globalization, low interest rate, it bleeds through, but now with falling multiples, higher financing costs like revenue growth margins just taking center stage. So as Madison was saying, it gets lost in the news. It gets lost in everything that first of all, the world isn't frozen, and second of all, the world is speaking to you in terms of this is different. There's change here, and people just need to realize the change because it's difficult to do because people are so caught up in their day to day. I mean, because my background is history, people are like, oh, you're caught in the past. I'm like, well, how did we get here? And the fact that we are here, are we recognizing that we're here and what will it take for someone to do something different? They're the key things, right?

Madison Murphy (10:58):

Yeah, and I think to that point too, I think private equity investors also have a little bit of PTSD from the GFC days when transaction volume fell, the

Lara Rhame (11:08):

Financial crisis was so devastating. Yeah,

Madison Murphy (11:10):

Absolutely. When transaction volume fell, 90% we're nowhere near that. We're also in a market now where the private equity market is just much larger. It's more complex, it's more developed. So we're by no means in that environment that we found ourselves in.

Phil O'Brien (11:28):

I mean, that's another thing we hit on is we talk about how the world has changed since the global financial crisis companies are staying private for longer.

Lara Rhame (11:38):

Yes.

Phil O'Brien (11:38):

That's such a good point. And then the amount of public companies that are there has shrunk as well. So sometimes And

Madison Murphy (11:43):

The quality

Phil O'Brien (11:43):

And the quality, we could talk about that. But I tell people, if 4% of companies in the US are public and 96% are private, what is an alternative?

Lara Rhame (11:54):

That's such so well said. I'm

Phil O'Brien (11:56):

Just saying. So well said. You've written about it. You've written about it that if 40% of companies don't make any money in the Russell, and that's up from 15, just the quality of maybe how that has changed and people's lack of awareness of that, how that has changed and how do we get to this point, right?

Madison Murphy (12:16):

And compare that then to the private middle market where 80% are reporting positive earnings. So

Phil O'Brien (12:25):

Once again, what was private and was something like off in the distance and was something just for the super wealthy. Now because of the buildup of how this has been because of rates, because of all this, it's something people really need to have a discussion about because it's behaving different. You've written a ton about it, how public markets are behaving different than the real economy. Maybe you want to talk about that a little bit. Right.

Lara Rhame (12:51):

Well, I think something, and I want to transition to something that we've already been teasing, which is that we kind of started with the big public universe. We moved to private. Now I want to sort of dig deeper into that private space and think about the difference between that the large cap private companies. I don't think people understand how many companies are really, how many large cap companies are still private and that the private equity market looks very different for the large cap and the middle market. So as we kind of transition from how do we get here to where are we going, I think I'm going to steal my airtime and talk briefly about my own interest rate outlook because today, and I'll timestamp it, we're recording on May 29th. The fed funds rate is call it five and a quarter, the band five and a quarter to five and a half. And we started the year expecting seven rate cuts. I think today we're only expecting one. Some days it's two, some days it's one. But it's changed

Phil O'Brien (13:51):

Though,

Lara Rhame (13:51):

Right? It's changed. I mean it's a tremendous pullback from really significant decline in short-term interest rates. And then long-term interest rates I would say have really just been stuck in a big range between four and a quarter and five. And I continue to believe that sometime this year in 2024, long-term rates are going to retest that 5% high that they hit last year. If you kind of look at the graph of 10 year treasuries, we're at sort of a slow uptrend and what's driving that? It's inflation that's stubbornly high. It's not a raging bonfire like it was in 2021, but it stuck around 3%. But you still have solid US growth. I'm happy to report there's no reason today to be really concerned about some sharp slowdown in the economy. And in fact, it looks like it's not really slowing down at all. It's still pushing ahead with two and a half, 3% growth.

(14:52):

It's very strong. And then three, supply and demand debt dynamics. We've got a big deficit. Our auction sizes are growing. So for those reasons, I feel like there's also a lot of complacency. I hear it all the time like, oh, the fed's going to still cut a lot and the yields have peaked. I worry that yields may have peaked in the short term. In the long term, we may continue to get this higher drift. And any way you slice it yields if yields are going to come down, they're not going to come down fast or they're probably not going to come down a lot in 2024. So when you look at that and you think about what you do with that, and we were talking earlier as we were prepping for this, about how there's no one definition. I'll just give a definition that Madison you mentioned in the blog and call the middle market space that we're discussing today is one that's broadly total enterprise value between 25 million and a billion, and that's 200,000 companies.

(15:55):

It accounts for a third of US private sector, GDP, and it employs 50 million people. This is not a bespoke one-off small investment footprint that we're looking at. It's a pretty big one. The largest economy in the world. Yeah, it's exactly another, I think a really useful way of thinking about the scale of this. I'll pitch it back to Madison to sort of talk to us more about the opportunities in the space and why in a world today. I think where there are a lot of risks, geopolitics, the public market has shrugged them off. Large cap private markets have maybe felt a little more uncertain and stagnant. You have phrased it so well. In this blog post. I'm going to give a teaser for this blog right now. It's the middle ground balancing fear, greed and returns with middle market private equity. I should have done that upfront. I'm going to do it a couple more times, but talk about why this space is so attractive right now.

Madison Murphy (16:58):

Yeah, I think the middle market is very well positioned to deliver strong risk adjusted returns in the go forward market. More so than large cap was large cap was very well positioned over the last 20 years. Now I think it's time for the mid-market to shine. So

Lara Rhame (17:16):

Again, as Phil says, this is a new environment that is, so there's one thing I can hammer home. It's that this is a new era and we're not leaving this, this isn't a flash in the pan quick rotation. This is where we're headed

Madison Murphy (17:31):

Between higher rates, between regionalization, between geopolitical uncertainty. The mid-market is very well positioned for a few different reasons. First and foremost is middle market companies have lower purchase price multiples than large cap, about 34% lower than large cap. And that's for a few different reasons. The market is fragmented, so there's a higher perceived risk because of that and because they're smaller companies earlier stage in the life cycle. So it definitely requires a skilled manager with the relationships, the knowledge to kind of navigate that environment to market.

Lara Rhame (18:09):

There are huge benefits to buying a company at a lower

Madison Murphy (18:11):

Multiple, lower multiple, especially when we're in an environment now going forward of higher interest rates. So there's less of a debt burden on the middle market manager. So again, lower pricing means lower leverage, and we see that in the market, mid-market buyouts require 32% less debt on average than large cap, which we speak to in the piece. They're just better positioned to, they don't need to carry

Phil O'Brien (18:40):

Debt levels

Madison Murphy (18:42):

Maybe. Yeah, the debt levels for these companies or for these managers is just substantially less. Well, and I

Lara Rhame (18:48):

Think when you think about when you take that to, you buy an investment, you buy a company, you buy a piece of a company, and you want to get that growth and get that return, you get it through operating revenue expansion. You get through one of my favorite graphs. Graph number two in this piece breaks down where that return go comes from. I love that graph. Yes,

Madison Murphy (19:08):

The value creation bridge. Yes.

Lara Rhame (19:09):

Right. Yeah. And it's margin, it's revenue, it's profit, and then it's valuation growth. And when you look at the advantage of buying in at a lower valuation, there's so much more growth to be harvested there.

Madison Murphy (19:24):

Yes. There's just more juice to squeeze from these middle market

Lara Rhame (19:27):

Companies. Large, there's aton large,

Phil O'Brien (19:28):

There's of ity, there's a ton of levers you can pull.

Madison Murphy (19:30):

Yeah, absolutely.

Phil O'Brien (19:32):

They don't have the same expectations, the same rate sensitivity.

Madison Murphy (19:36):

They rely,

Lara Rhame (19:38):

Yeah,

Madison Murphy (19:38):

They're less subjected to, or they're less sensitive to what's going on in the public market. They're more insulated because they're less rate sensitive.

Phil O'Brien (19:46):

I was talking to an advisor and I said, it's going to sound corny, but in some ways I see the public markets like the house because I think you raised a point on podcast before. There's an employment number, but nobody acts on the revision. So the Senate is more like the private markets. They have time to digest the news and all the facts that you've mentioned, these companies can do more. They don't have the burden, they're not as rate sensitive. They're growing. They have the optionality and they're doing the right thing.

Madison Murphy (20:16):

And these mid-market managers have relied on those levers. They've relied on growing firms, revenue streams, revitalizing management teams, and increasing margins. And we've seen this play out through history.

Phil O'Brien (20:30):

So would you say that's more of a chance of this better internal growth with these companies rather than the large cap space, which is valuation driven and more like chopping down a business rather than building a business? Yes. That's

Lara Rhame (20:42):

The fuel

Madison Murphy (20:42):

You get.

Lara Rhame (20:42):

Absolutely.

Madison Murphy (20:43):

Yeah. And these mid-market managers, growth capital, multiple growth has come from revenue growth and margin expansion.

Phil O'Brien (20:51):

So it's internal growth and controlling your own destiny more.

Madison Murphy (20:53):

Yes,

Lara Rhame (20:54):

Absolutely. I think, Phil, I've heard you also talk about US middle market versus Europe. I think again, something, and I know you and I have long and passionate experience in global asset allocation, there's always a place for that in a portfolio. But I think when you think about today and real growth opportunity, I almost call it doubling down on the US economy. I think there are really important positives in the US in a global context.

Phil O'Brien (21:25):

I think you're spot on. I mean, it's a lot of what Madison was saying, it's just structurally you can do more here. I mean, being from Ireland, the way the European unit is set up that it's kind of restrictive in some ways it's more regionalized. But here's the thing, the US middle market is that bullseye of the action. It's 90% of the buyouts over the last decade. So there was one thing I was reading recently, and they were talking about leadership in middle markets on a global basis, and they were just saying the US middle market, they're really bullish on the profits. So if you look at middle market companies, 70% of them expect to profitability over the next year. That's super upbeat. If I go to Latin America, it's 63%. If I go to Asia Pacific, it's 56 EMEA 58. But Europe, it's only 45% of companies. And it was in the news that part of what we're doing here with the various government programs, with the resiliency of the economy is that the middle market here in terms of de-globalization, in government support, all these regions are doing different things, but they're not getting it together as quick as we are here and putting it into action just so they're not as integrated. There's not as many opportunities for growth.

Lara Rhame (22:42):

So when I

Phil O'Brien (22:42):

Think about the middle market,

Lara Rhame (22:43):

They're quite as agile. Even though our economy is so large, it actually really is more agile. We don't

Phil O'Brien (22:47):

Have the borders internally within the states. We speak the same language mostly.

Madison Murphy (22:52):

I mean look at just last year, they just narrowly avoid a technical recession in the second half of 2023

Lara Rhame (22:58):

In Europe. Meanwhile,

Madison Murphy (22:59):

We had a nominal GDP of

Lara Rhame (23:01):

6%. Yeah, 6% growth.

Phil O'Brien (23:03):

But we've put the money to work. And I remember on the podcast last year you did about, you were talking about the government spend on third quarter of last year. Yeah, tremend. So you can follow where the spend is, you can build around it. Versus in Europe, you haven't seen the same spend. You just haven't seen the same onus on native industry. Right.

Lara Rhame (23:20):

Yeah. Yeah. I think one topic that is so critical to cover is if the private equity market feels a little stalled right now because we have seen a drop in deal flow, I fully believe these markets will acclimate to higher rates, but it could be a longer process. Why are we telling people to go into this sector right now and why is the middle market attractive at a time when deal flow is arguably lower?

Madison Murphy (23:47):

Yeah, so I mean like we were speaking about earlier, the private equity market is in this stalled state, but we've seen the middle market fairing much better. The transactions are smaller, so they're cheaper to purchase. Like we mentioned, they require less of a debt burden. And we've already seen the market starting to pick up in the middle market in Q4, transaction volume was up 10% versus the broader bio market, which was down 4%. Yeah. So the middle market accountant for a record amount of deal flows in Q4 of last year.

Lara Rhame (24:21):

And you see it continuing.

Madison Murphy (24:23):

And it's continuing. Yes. Quinn just published an article actually this morning that said that middle market buyouts accounted for 90% of deal flow this quarter and Q 90%. So

Phil O'Brien (24:35):

That's up as well. Keeps

Madison Murphy (24:36):

Coming up. That's up. Yeah. Okay.

Lara Rhame (24:37):

That's up. I think, Phil, something I've heard you say a lot is that one person's exit strategy is another investor's entry point. I think an area that we focus a lot on is the secondaries slice of private equity. Will you just describe for everybody what that is?

Phil O'Brien (24:54):

For sure. I mean, you could go in to buy a primary fund, you give your money, you have the J curve, you don't know where the money's going to go versus what we're seeing right now with the denominator effect of people's allocation for institutions getting out of effect because public markets have done well or vice versa, they have to reallocate or they have to make a change or there's a free up capital. But the secondary market is super interesting because what you get to do there is you get the immediate deployment of capital, you get to look at what you're buying. So it's typically in year four or five when the money's being put to work. So you don't have to j curve. So you get to mitigate some of the blind risks by actually seeing these are companies that are profitable, I like them, I can go in there, I can take a slice of the action, and they're going to have less of a loss ratio because you're buying more of a known quantity.

(25:43):

However, I think back to your point and the points I raised, and there's a lot of generalizations about the quality of your buying. So the point that we make here at FS is I can buy a secondary at a massive discount and I can mark it up and who benefits from that? Or I can buy a secondary of really high quality companies that aren't using as much leverage to your point, that have the optionality where you're not buying as much a discount, but you're trying to capture that growth potential year over year. You're trying to capture that earnings potential year over year. So if we would, and I think what we're trying to do here is narrow it down to say there is an opportunity for middle market. When you get into the middle market, everything isn't equal the same way as public markets. So buyer beware, buy companies that can generate that revenue where you don't mind paying up where you know the management. So it's just more of the same, but just really focused down on what you're getting, why you're getting and what you want to do with it.

Lara Rhame (26:43):

Yeah, sure.

Madison Murphy (26:44):

That point on the discounts really hits home for me because I know I can't tell you how many times I'll buy a skirt from anthropology and just look at the 40% discount tag and then never wear that skirt once and it sits in my closet for the next three years. You did. I was because I was so focused on that discount, but you got to remember the value of it.

Phil O'Brien (27:04):

The

Madison Murphy (27:05):

Quality of that skirt just wasn't there.

Phil O'Brien (27:07):

I don't know how many times I said to my wife, this looks like a real deal. And she goes, for what? Why are you buying that same questions to settle me down? Why are you buying it? How is it useful on a go forward basis? But did

Madison Murphy (27:19):

You see that sale? Where's the

Phil O'Brien (27:20):

Quality of it? I know.

Lara Rhame (27:23):

So Madison, I think you and your piece highlight four really good foundational reasons to consider middle market private equity. Just let's just hammer, what are the four reasons?

Madison Murphy (27:37):

Absolutely. So the first is lower prices. As we mentioned, lower prices begets lower debt. That's our second. So lower leverage is required for these middle market buyouts. Third, middle market firms rely more on operational improvements than leverage. So these companies are smaller, so there's more juice to squeeze, there's more levers that they can pull on to drive value. They can grow an acquired firm's revenue, they can revitalize the management team, they can increase margins. They have all of these different levers to pull versus large cap where it's mostly leverage that they're relying on. Yeah,

Lara Rhame ([28:17](28:17)):

Less. This is back to the valuation bridge, right? Exactly. That I had my favorite chart mention again.

Madison Murphy ([28:22](28:22)):

Yep, exactly. And in that chart, you can see that middle market managers, 75% of the growth, the capital multiple growth is coming from revenue and margin expansion, which that's verse 52% for large cap. So much smaller.

Lara Rhame ([28:38](28:38)):

Much smaller. Alright, so what's the fourth

Madison Murphy ([28:39](28:39)):

Reason? Yes, the fourth reason is middle market companies have greater exit optionality. So large cap companies are really kind of subjected to the IPO market, which we know is challenged right now, but middle market companies, historically only 7% of exits have come from IPOs versus 30% for a large cap.

Lara Rhame ([29:02](29:02)):

This is something that I feel like is deeply underappreciated. People think bigger is better. That's what kind of public markets have been telling us forever. In the private space, there are huge advantages to being an investor in the middle market companies because there are so many different ways. There's

Madison Murphy ([29:23](29:23)):

More buyers to

Lara Rhame ([29:23](29:23)):

Exit that

Madison Murphy ([29:24](29:24)):

There's just more buyers. You're more downstream versus a large cap manager where the market is limited and they have to turn to the public markets. And

Lara Rhame ([29:31](29:31)):

If you want to do a big LBO and you're a giant private company,

Madison Murphy ([29:34](29:34)):

You're really, you only have a handful of buyers beholden

Lara Rhame ([29:36](29:36)):

To

Madison Murphy (29:36):

Handful, only handful. Handful of sponsors. Absolutely.

Phil O'Brien (29:39):

And a favorable time in the market to do it. Yeah.

Lara Rhame (29:41):

Yes.

Madison Murphy (29:43):

Whereas mid-market can rely, has a much bigger pool of private equity firms and sponsors, higher upstream as well as corporate buyers too. And really that exit optionality exits are really kind of the log jam that we're seeing right now in what's driving this stalled private equity market. So if you can access those exits and you can give LPs liquidity, that's where you're going to kind of see that fundraising cycle continue to flow, and you're going to see movement and you're going to see growth

Phil O'Brien (30:14):

And you are right to your point

Madison Murphy (30:15):

And yeah, you're seeing it now. Exactly. So the market is speaking, we said, yep, we saw exit volume pick up 14% last quarter.

Lara Rhame (30:22):

All right. So I guess I think in mid-market, what this means is we need to come back again in a couple of months and check back in on how all of this has evolved and how the market is starting to really come back to life and how middle markets are going to be a key driver of that.

Madison Murphy (30:38):

Yeah, absolutely. I have that. You got to

Phil O'Brien (30:40):

Watch this space, right?

Lara Rhame (30:41):

Yeah, definitely.

Phil O'Brien (30:43):

Not that it's going away, but it's getting bigger. It's really revealing itself more. Yeah, for

Lara Rhame (30:47):

Sure. Alright, well Phil Madison, this was fun. You guys think your first F as Farside podcast

Madison Murphy (30:55):

It? I survived. It was great. It was great. It's always fun going back and forth with you, Lara. I feel always great.

Lara Rhame (31:02):

I feel like we talk about all this stuff anyway. We might as well record it. It put a camera in front of me

Madison Murphy (31:06):

And a microphone in front of me. Yeah.

Phil O'Brien (31:07):

Yeah. I mean for us, for what we do, you're trying to get ahead of the crowd. You're trying to show things that people don't see. So the more opportunities you get to speak and just some of the statistics you have and the environment that you have, we're just going to have to get out there and help people try and see what's really happening and try and see how we can help, right?

Lara Rhame (31:28):

Yes,

Madison Murphy (31:28):

Definitely. It's always so interesting hearing your feedback in the field and your conversations with advisors and what they're worried about and what's top of mind for them.

Phil O'Brien (31:37):

It's early days, but I mean people are starting to get the recognition. I mean, I give talks, I talk to clients and advisors don't think about how much doing client events that people actually get. But when you sit down and talk about the middle market and you talk about real companies and you talk about these are companies with their neighbors, their friends, these are real businesses. It's not an alternative. They get it. They get this more than they get the stock market, they get this. This is real to them.

Lara Rhame (32:07):

So I think that's where I'll put a final bow on it, which is just that I talk a lot about how the largest companies that dominate the s and p 500 aren't really great representatives of the overall US economy and that the 200,000 companies in the middle market are a much better mirror for how the economy's looking. So the middle market is a space that FS investments offers a ton of strategies around. We love to talk about it, we love to educate on it. I'm going to wrap us up with a couple of really amazing pieces that the links were all in the show notes, but I hope that you'll take the time to learn more. The one that we really talked about a lot today is the middle ground balancing fear, greed and returns with middle market equity. Madison, your other blog on the diversification dilemma and using a low correlated alternative investment solutions is just really worth a read as well.

(33:07):

And then Andrew Korz and I wrote that chart book on journey to the heart of the economy and talked about why public vehicles for the middle market like the Russell 2000 are really a poor quality mirror of the strong growth and investment opportunities that you need to access with private equity. So those are my three little advertisements. We're passionate about education and I know we'll continue this conversation. So awesome. Thanks for joining me. Thank thanks for trusting us with the mic. Thank you. This was fun. So much fun. Thanks.

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