RESEARCH INSIGHTS FROM GEM

The Case for Small Buyouts

Backing Managers Early in the Lower Middle Market

Why we believe emerging managers and independent sponsors are among the most durable—and least crowded—sources of potential equity outperformance.

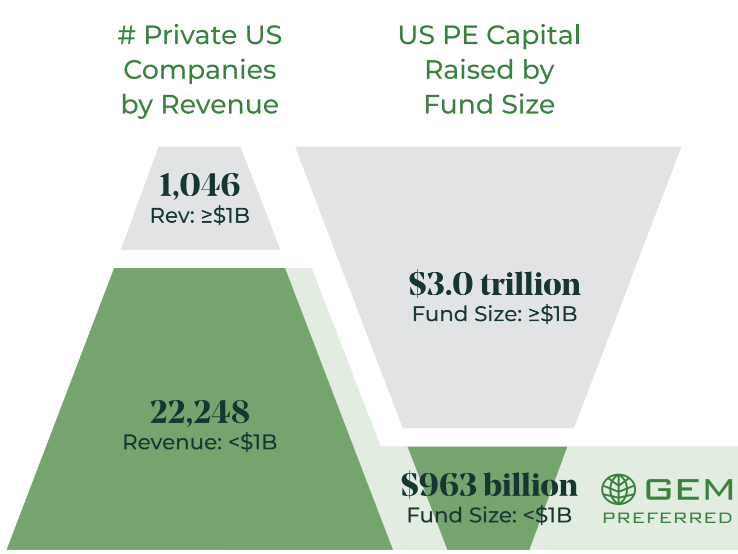
GEM

An asset class that rewards selection

For most of the past two decades, the private equity conversation has centered on a single question: can private equity beat public markets? For many allocators, the debate was at the asset class level, hinging on the macro forces shaping capital flows and valuations. But the new economic regime, defined by higher interest rates, macro volatility, and a tech-driven disruption to business models, largely renders that debate moot. The more critical question today is both narrower and more difficult to answer: *where does durable outperformance come from now that the last cycle's tailwinds have faded?*

In many respects, the private equity ecosystem has bifurcated between those firms that leverage scale and debt and those that drive earnings growth through operating expertise. But with distributions across the industry still lagging on sluggish exit activity, LPs have retrenched toward a narrow set of that former group: larger, established managers with strong historical track records, perceived as a "safe pair of hands," leaving the broader field, and the smaller end of the buyout market in particular, comparatively starved of capital.[1,2] At the same time, the "democratization" of private markets via interval funds, evergreen and semi-liquid vehicles, and a fast-growing secondary market is drawing a new class of capital into the larger segments of the asset class. The result is likely compressed forward returns at the industry level, but increased dispersion at the strategy and manager level, attributable to execution.

Small buyouts represent 80%+ of the market opportunity, but only ~20% of capital



Source: PitchBook (2025 US PE Breakdown). Private company count includes all US-based, privately held companies that have completed a transaction since 2008, as tracked by PitchBook.

We believe that dynamic should point investors *toward* small buyouts, one of the least crowded corners of the asset class. GEM's primary target is the broader opportunity set of the **lower middle market**—companies acquired below roughly $100 million of enterprise value—with a particular focus on independent sponsors and managers who have proven playbooks for improving company earnings through operational change. In our view, this is the part of the market least dependent on tailwinds that have now faded—cheap leverage, multiple expansion, and open exit windows—and most closely tied to skill that we expect to be resilient through cycles: operational value creation by experienced, aligned, and motivated managers.

Our support for small buyouts reflects GEM's broader approach to building portfolios for a long horizon client base: leaning into our sources of advantage that are most likely to be durable, and treating dislocation and dispersion as conditions to underwrite with discipline rather than risks to avoid.

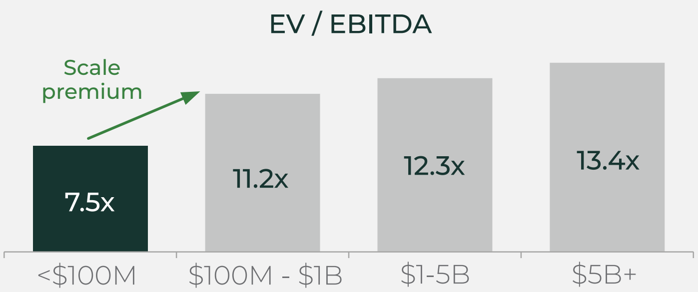
Why the lower middle market is structurally advantaged

The appeal of this market can be reduced to a simple, consistent formula that plays out across the life of an investment: buy at an attractive price, improve the business, and sell into a deep pool of buyers—or, as our team puts it, **buy low, fix up, sell high**. Unlike at the top of the market, where assets are typically well priced and returns are often manufactured through financial engineering, in the lower middle market, much of the return comes from a manager's ability to improve the business itself. In our view, this insulation matters more now that the software-led multiple expansion of the past cycle—a tailwind concentrated in large-cap technology—has largely run its course. Because the lower middle market skews toward business and consumer products and services rather than technology, its returns are less a function of that wave, and less exposed to its potential reversal.

The case for the lower middle market

- **Attractive entry, with a margin of safety** (BUY LOW). Sponsors in this market frequently acquire companies through relationships rather than competitive auctions, which can support a discount to prevailing valuations and add a margin of safety at entry. Companies are typically purchased at mid- to high-single-digit EBITDA multiples, with prudent leverage of up to four turns of cash flow. This tends to make returns less dependent on excessive use of debt and a company's profitability less exposed to a rise in interest expenses. The structural backdrop reinforces the advantage: far more companies sit in the lower middle market than there is capital pursuing them, even as new money continues to concentrate in the largest funds.[2]
- **Real room to create value** (FIX UP). These are typically founder-owned businesses with roughly $10–50 million of revenue that have never been professionalized—many have never had a CFO or COO, lack a professional sales function, or do not yet run on a modern Enterprise Resource Planning (ERP) system. Therein lies the opportunity: institutionalizing a fundamentally sound but unpolished company, by building out finance and systems, upgrading the team, adding capacity, or pursuing add-on M&A, is where value can be created. Small buyout data supports this premise: earnings growth (revenue times margin) accounted for approximately 73% of observed enterprise-value creation, compared with 27% from exit-multiple expansion.[3]
- **A deeper pool of buyers and a step-up at exit** (SELL HIGH). A company that has been improved and institutionalized can become an attractive target for larger private equity firms. Middle-market private equity holds substantial dry powder, is often looking for scaled, de-risked assets coming out of the small buyout market, and is frequently willing to pay a higher multiple than the sponsor paid at entry. The reward for a successful transformation is thus twofold: earnings growth compounded by multiple expansion.

Entry multiples are typically lower for smaller transactions, leaving room for a step-up at exit



Source: PitchBook, 2Q 2026 Global M&A Report.

Because more of the return is earned through operational change than through leverage or market beta, manager skill tends to matter more than the market backdrop. That is both the opportunity and the challenge.

What history tells us: outperformance with underlying dispersion

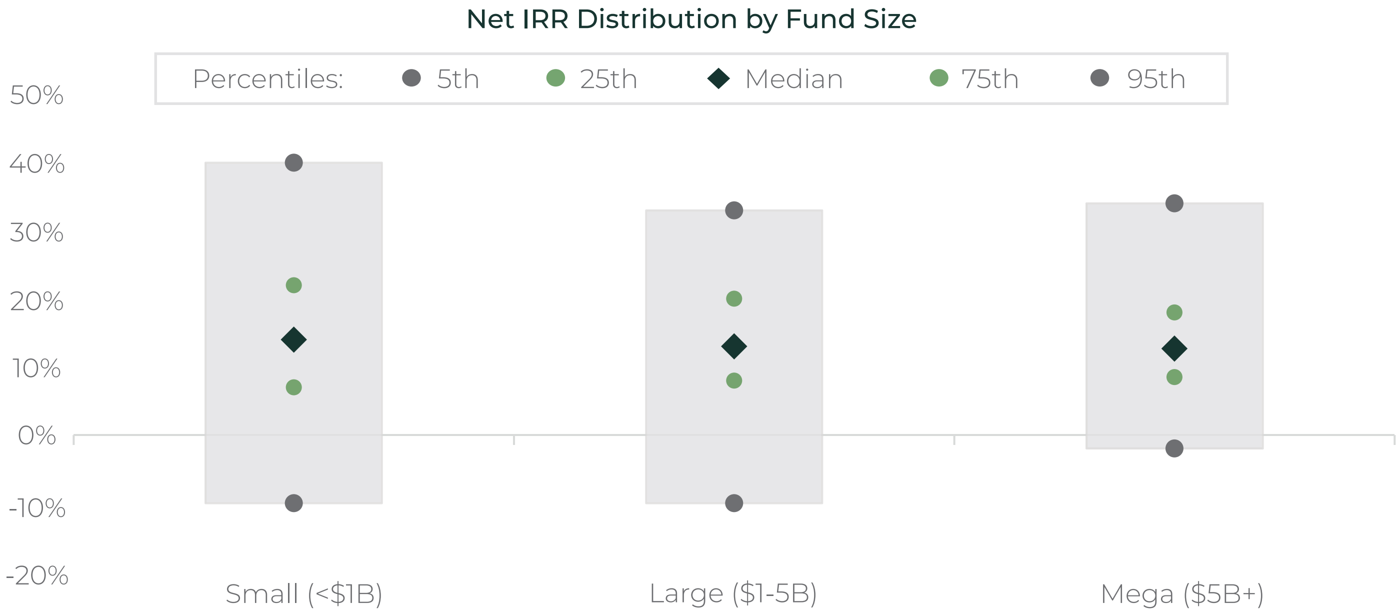
Long-run data consistently favors the small end of the buyout market, with one qualifier.

The case for small buyouts

- **Higher median and upper-quartile returns.** Across strategies, small buyout funds (under $1 billion) have historically shown a higher median and a higher top-quartile return than large buyouts, venture capital, real estate, and private credit.[4]
- **Enduring edge over large buyouts.** Small buyouts' top-quartile funds outperformed large buyouts' top-quartile funds in 15 of 16 vintage years from 2007 to 2022.[4]
- **More frequent outsized outcomes.** Data on fully realized U.S. buyout and growth equity investments shows that small-cap transactions (here defined as enterprise values under $250 million) generated gross, deal-level MOICs of 5x or more at a meaningfully higher rate than large-cap transactions (13% versus 5%).[5]

The qualifier: dispersion is wide, and the left tail is real. The same features that create upside—thinner information, bespoke situations, smaller and less proven companies—also widen the range of outcomes. The reward for being in this market can be significant, but so is the penalty for poor selection. **In the lower middle market, manager selection is arguably the defining factor for an investment's success.**

Selection matters most in small buyout, where top-quartile returns are highest, but dispersion is widest



Source: MSCI Private Capital (formerly Burgiss), as of 3/31/2026; N. American buyout funds, 1999–2025.

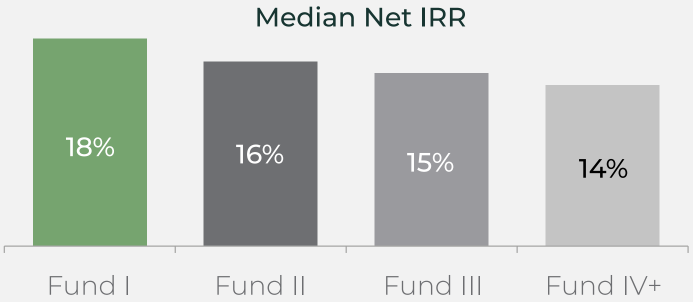
An underappreciated edge: emerging managers

Emerging managers have long carried a "high risk, high reward" reputation that has pushed them to the margins of many institutional portfolios. Recent evidence suggests that reputation is only partly deserved: while the reward is real, the risk has likely been overstated, in part because the "emerging" label conflates two different things. A first-time fund is not the same as a first-time *investor*; the most compelling emerging managers are often experienced professionals—frequently former deal leads at established firms—raising their own vehicle for the first time. In a 2026 study of first-time (Fund I) managers, StepStone found that early funds skewed toward the high-reward end of the spectrum, and that LPs who avoided Fund Is forwent a meaningful source of alpha.[6]

The case for emerging managers

- Historical data suggests **early funds are more likely to outperform, and the edge fades with each successive fund.** Funds I and II beat the median roughly 60% of the time, versus about 50% for Fund IV and beyond.[6]
- **Smaller inaugural funds have performed better historically.** Among Fund Is below $500 million, 67% delivered above-median returns, versus 44% for funds between $500 million and $1 billion. This reflects smaller funds' tendency to buy smaller companies with more valuation inefficiency and less leverage.[6]

Early funds are more likely to outperform, with returns declining with each successive fund.



Source: StepStone (SPI) and MSCI, as of 6/30/2025; buyout vintages 2001–2020.

- **Experience matters.** Founder experience has shown a strong positive relationship with performance, challenging the belief that first-time managers win on drive alone. Seasoned founders have benefitted from cross-cycle perspective, deeper networks, and stronger pattern recognition.[7] This is the empirical backbone of a principle GEM has long held: compelling first-time managers are "*Fund 1 on the cover, Fund 3 in their career.*"
- **Winners tend to persist.** Among managers who delivered top-quartile Fund I performance, 43% did so again in Fund II, and 66% beat the median. Identifying a winner early has potential to compound across vintages into a durable partnership.[6]

For GEM, emerging manager discovery is a core discipline in our approach to investing in buyouts. We believe buyout is an apprenticeship business—nearly every new firm reflects where its founders trained—so GEM assesses the parent firm before taking a view on the individual who leaves it. We have a dedicated sourcing team that monitors this market full-time, targeting managers on their third fund or earlier, or funds below $1 billion. We believe this proactive, ongoing monitoring adds value for our investors in two ways: (1) GP discovery (identifying under-the-radar managers before they are widely known) and (2) GP access (positioning us to win capacity with managers who are likely to be oversubscribed).

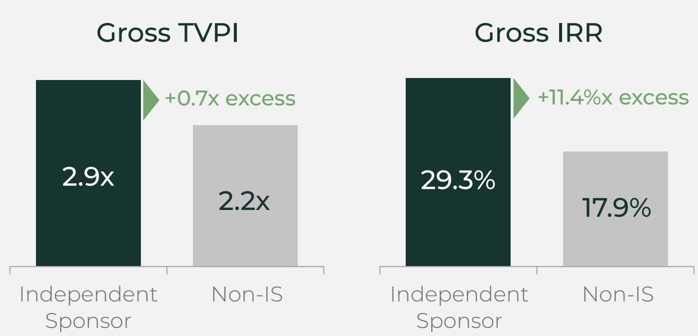
The frontier: independent sponsors

If emerging managers are the earliest institutional entry point into a fund franchise, independent sponsors are a step earlier in the GP life cycle. An independent sponsor sources, negotiates, and diligences an acquisition one deal at a time, *without a pre-raised, committed pool of capital*, then raises the equity and debt for each transaction. That structure exists for a reason: when a senior investor leaves an established firm, the track record usually stays behind, so even highly credible operators often seek to establish an attributable record on their own, on a deal-by-deal basis, before raising a fund. Until recently, the segment was under-studied; a 2026 analysis from the Institute for Private Capital at UNC Kenan-Flagler—the first large-sample study of the space, covering more than 800 transactions—now provides real data.

The case for independent sponsors

- **It has professionalized into an industry.** Two-thirds of transactions have been completed by serial sponsors with three or more deals, two-thirds of sponsors operate with two or more partners, and most bring backgrounds in private equity (88%) and investment banking (71%), with operating (63%) and industry (50%) expertise.[7]
- **It sits squarely in the less-crowded lower middle market.** Typical enterprise values have run $10–50 million with $2–10 million of EBITDA, tilted toward business and consumer products and services rather than the technology and healthcare deals that now dominate large-cap buyouts.[7]
- **Returns have been strong.** For fully exited deals, gross TVPI averaged 2.9x (median 2.1x) and gross IRR averaged 29% (median 24%). Benchmarked against carefully matched, non-sponsor buyouts of the same size and vintage from the MSCI Private Capital Universe, independent sponsor deals showed excess mean TVPI of +0.73 and excess mean IRR of +11.4%.[7] Furthermore, independent sponsor transactions were usually completed at a discount to fund economics making the gross to net spread narrower than traditional fund investing.

Independent sponsor deals have outperformed matched non-IS buyouts of the same size and vintage



Source: Institute for Private Capital (Brown & Volckmann, 2026); MSCI Private Capital Universe.

- **Upside does not necessarily come from taking more risk.** A fair question is whether these returns simply reflect greater risk-taking. The data suggests they do not. Loss incidence for sponsor deals was just marginally higher than the benchmark (23.5% vs. 21.6%), implying outperformance has been driven by greater upside and a superior risk-adjusted return.[7]

GEM has made the same case publicly: as our Investment Research Team has noted, deal-by-deal independent sponsor structures can create strong alignment between sponsors and investors and, increasingly, are outperforming traditional buyout funds.[2] Because dispersion is wide, skill in selecting these investments can drive outperformance.[7]

Why GEM: turning selection into an edge

Read together, these three independent bodies of evidence—the broad small-buyout record, the emerging manager data, and the independent sponsor study—reinforce the same conclusion: excess returns are more likely in the lower middle market, and those returns accrue disproportionately to investors who can correctly distinguish the top quartile from the bottom. The opportunity is real, and the edge is selection.

That is the buyout program GEM has sought to build. We do not treat emerging managers and independent sponsors as an exception to a large-cap program, they are a core discipline. Our sourcing, diligence, and partnership model is organized around identifying promising managers early and selecting well.

GEM's approach to buyout investing

- **Back managers early.** We prefer to invest with managers in Fund I, Fund II, and on a pre-fund basis with independent sponsors. We are often the first institutional capital, where economics, capacity, and access are typically more favorable.
- **Target the investment profile that data rewards.** We look for managers who were true deal leads at established firms—"*Fund 1 on the cover, Fund 3 in their career*"—the experienced-founder profile that evidence shows is well-positioned to outperform.
- **Do the work that selection requires.** Our conversations often begin before a manager has left their prior firm. With no formal marketing materials and no three-fund track record, we reconstruct an attributable record deal by deal, conduct references with portfolio company CEOs and former colleagues, and assist new managers with the operational and administrative build-out of a new firm, helping to enable the manager to focus on investing. We also believe pre-fund co-investments are one of our best diligence opportunities: made before a manager raises a blind pool, they reveal the intangibles a track record cannot; this includes the manager's willingness to walk away from a deal, which we have found correlates strongly with longer-term success.
- **Build for persistence.** Because data has shown that top-quartile early funds tend to stay top-quartile, identifying a winner can be the start of a multi-fund relationship, compounding a single strong selection across vintages.

Our discipline is reflected in the numbers. Since 2015, our dedicated sourcing team has evaluated more than 7,800 small buyout opportunities and committed to just 155 (<2%) of them—a deliberately high bar given our belief that manager and deal selection is what drives outcomes in this market. Over that period, we have committed more than $2.8 billion to the strategy. We believe this represents one of the largest small buyout programs in the United States.[8]

In practice: two case studies

The following case studies illustrate our approach with examples from GEM's buyout portfolio—one an independent sponsor investment, the other a manager we have backed across successive funds.

1. Backing a specialist sponsor's healthcare thesis.

GEM invested alongside a healthcare-focused independent sponsor on a deal-by-deal basis. The sponsor's health insurance brokerage platform focuses on the government-sponsored health plan market. The investment was underwritten around favorable demographic and market tailwinds—growth in Medicare Advantage and rising complexity in healthcare enrollment—and around a disciplined entry valuation.

Since our investment, the sponsor has executed its value-creation playbook the way this market rewards: organically expanding the Medicare Advantage broker base, launching a new ACA business, and completing selective add-on acquisitions that broadened the company's scale and product capabilities. The investment reflects our conviction in the sponsor's research-driven approach, valuation discipline, and ability to execute a clear healthcare-services thesis: buy low, fix up, with a potential path to sell high, in a single deal.

2. Backing an operations-led industrial specialist across its funds.

We partnered with an operationally-oriented lower-middle-market buyout firm focused on niche manufacturing and industrial-services businesses, the kind of less-intermediated segment where operating skill matters more than leverage. The firm's founders built their expertise as senior operators at large industrial companies, and they pair that operating background with a disciplined, diligence-led approach: identifying concrete opportunities for improvement early in underwriting, entering at conservative valuations, and executing a buy-and-build strategy that diversifies end markets and scales platforms over time. The firm also has a deep bench of seasoned operators it can draw from to install in its companies.

Our conviction rests on the manager's ability to build rapport with founder-owned businesses, to surface actionable improvements early, and to work to convert them into both earnings growth and multiple expansion. It is a differentiated sector specialist with a playbook we believe is repeatable, and one we have backed across multiple funds and alongside in a co-investment, the kind of multi-fund relationship that compounds a single strong selection over time.

Conclusion

Industry maturation and an evolved economic regime have forced allocators to think about the role of private equity differently. While the lower-cost-of-capital crowd chases "access" in large institutional funds, we believe the odds of that segment beating public markets are low. The durable edge, in our opinion, lies at the other end of the barbell: in smaller companies, bought at lower prices with less debt, and rebuilt through operational work by managers who must earn every point of return. The potential for outperformance is real and independently corroborated, but so too is the caveat: dispersion in buyouts is wide, especially at the small end of the market, which makes manager selection central to success. That is what we have endeavored to build GEM to do: find the next promising manager, and earn the right to be their partner of choice.

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ABOUT GEM

GEM is an independent investment management firm that provides customized solutions for long-term investors worldwide. Since 2007, we have sought to deliver superior risk-adjusted returns to our clients by combining disciplined investment research and active portfolio management with exceptional service and enduring partnership. With a global platform, broad institutional investment capabilities, and an experienced team, we design portfolios to meet the unique needs of each investor we serve.

For more information, visit www.geminvestments.com.

Connect with our team:
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ENDNOTES

[1] Bain & Company, Global Private Equity Report 2026 (concentration of fundraising in the largest managers; decline in fund counts).

[2] PitchBook, 2025 Annual U.S. PE Breakdown. Private company count includes all U.S.-based, privately held companies that have completed a transaction since 2008, as tracked by PitchBook.

[3] CEPRES, Unlocking Growth: The Revenue-Driven Playbook for Small-Cap PE Success, analysis of value-creation drivers in small-cap private-equity deals, May 15, 2025.

[4] MSCI (fund-level net performance for global buyout, venture capital, real estate, and private credit strategies; return dispersion by strategy and vintage). Small buyouts defined as <$1B in fund size.

[5] Cambridge Associates, US Private Equity Looking Back, Looking Forward: Ten Years of CA Operating Metrics, November 3, 2022.

[6] StepStone Group, The Case for Emerging Managers (2026), drawing on StepStone's SPI platform.

[7] Brown, G.W. & Volckmann, W.M., Independent Sponsors: Investment Characteristics and Performance, Institute for Private Capital, UNC Kenan-Flagler Business School (2026); benchmarking uses the MSCI Private Capital Universe.

[8] Largest as defined by deal count activity over the history of GEM's independent sponsor and small buyout program.

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