Lower Middle Market Buyouts (Private Equity)

Interview preparation summary · PE track

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INT.LM.1.a · The lower middle market and winning deals

Explain what the lower middle market is, how its companies and deals differ from the middle and large cap markets, and why an investor would choose it.

The lower middle market is the segment of buyouts where the target companies are small: typically founder-owned, family-owned or owner-managed businesses with modest earnings. Definitions vary by firm and by region and are usually quoted as a range of EBITDA or enterprise value, so in an interview say which range the fund you are talking to uses rather than quoting one cut-off as a rule. The differences from the middle and large cap markets follow from size. There is usually less competition for each deal and fewer broad auctions, so more deals are sourced directly and priced bilaterally. Entry multiples are often lower, because the companies are smaller, less liquid and riskier. Information is thinner: accounts may be unaudited, reporting is basic and the owner holds much of the knowledge. Key-person and succession risk is high, because the founder may hold the customer relationships and the decisions. Management benches are shallow and finance functions are light. Debt capacity is lower, so equity makes up more of the price. The case for the segment is that these gaps can be closed by a good investor: better reporting, a stronger team, add-on acquisitions, and an eventual sale to a larger buyer who pays more for a bigger, better-run company. The honest counterpoint is that smaller companies fail more often and can lose a customer or a founder suddenly, so the segment needs a portfolio, careful diligence and conservative structures. Interview point: define the segment loosely, name three differences, and say what risk comes with each.

WORKED EXAMPLE: WHY A FOUNDER-OWNED BUSINESS IS PRICED BELOW A LARGE LISTED PEER

Fenwick Supplies is an invented, family-owned distributor with revenue of 24 million and EBITDA of 3.0 million. Its accounts are unaudited, the founder personally manages accounts worth 60% of revenue, and there is no finance director. The seller asks for 6.0 times EBITDA. A large listed distributor in the same sector trades at about 10.0 times. What is the gap in value, what explains it, and what would you need to believe to pay 6.0 times?

Answer: The gap is 12.0 million (18.0 against 30.0). It reflects size, founder dependence and unverified earnings, so it is only a bargain if diligence confirms the earnings and the plan closes the gap.

> **Interview tip:** Do not call a lower multiple cheap. Say what the discount pays for and what you would do to earn it back. The interviewer listens for whether you see the multiple as a price for risk.

INT.LM.1.b · The lower middle market and winning deals

Describe how lower middle market deals are sourced, including proprietary and off-market origination, intermediaries and the add-on pipeline, and explain how to win a founder over a larger bidder.

Sourcing is the main skill in this segment because so many targets are not for sale in any formal sense. Proprietary or off-market origination means reaching a deal through a direct relationship with the owner, so the fund negotiates alone or with few rivals rather than in a broad auction. The common channels are direct outreach to owners in a chosen sector, long-running relationships with accountants, lawyers, bankers and industry bodies, smaller advisory firms and brokers who run limited or informal processes, and introductions from existing portfolio company management. A platform company also generates its own add-on pipeline, because its managers know the smaller competitors and suppliers around them. Proprietary does not mean cheap: owners talk to advisers, and a founder who has had one conversation with a rival will anchor on it, so price discipline is still needed. Origination is a funnel with low conversion, so volume, sector focus and persistence matter, and the work is spread over years because an owner may take years to decide to sell. Winning a founder is about more than price. Founders often care about the future of employees, legacy, speed and certainty of closing, keeping a role and a stake,

and a partner who adds something. A fund that offers a rollover stake, a credible plan, references from other founders and a clean, quick process can win against a higher headline price from a larger fund, provided it is honest about the price it can pay. Interview point: describe the funnel, then say why a founder would choose you.

WORKED EXAMPLE: WHAT A DIRECT OUTREACH CAMPAIGN YIELDS

A fund writes to 250 owners of small specialist engineering firms. 20% reply, 40% of those agree to a meeting, 25% of meetings lead to an indication of price, and 40% of indications end in a completed deal. How many deals complete, and what does it say about origination?

Answer: Two deals complete from 250 letters. Proprietary origination is a patient, sector-focused funnel, and conversion depends on trust and fit as well as price.

> **Interview tip:** Give the funnel figures, then say what you would do to lift conversion. The interviewer listens for realism about how few approaches become deals.

INT.LM.2.a · Financing and diligence

Explain how lower middle market buyouts are financed, including limited debt capacity, senior debt, seller notes, unitranche, earn-outs and rollover equity, and show how they change returns.

Smaller, less diversified companies support less debt. Lenders usually offer a lower multiple of EBITDA than in large buyouts, with a higher margin and tighter covenants, so equity is a bigger part of the price and returns lean less on leverage. To fill the gap and bridge disagreements about value, several tools are used. Senior debt from a bank or debt fund is the main loan. A unitranche is a single facility that blends senior and junior debt under one lender and one set of documents, which is quicker and simpler but costs more than plain senior debt. A seller note is a loan from the seller, deferring part of the price, normally ranking behind the senior lenders. An earn-out is part of the price paid later only if the business hits agreed targets, usually profit, which lets the buyer pay a higher headline price for a lower upfront cost and lowers the risk of overpaying. Earn-outs need clear definitions of the measure because disputes are common, and a founder who controls the business during the period may push short-term profit. Rollover equity is the founder reinvesting part of the proceeds in the new structure, which reduces the cash the sponsor needs, keeps the founder motivated and gives them a second payout at exit. Counsel handles the legal and tax detail. Interview point: work out the sponsor cheque after all sources, and say how lower leverage changes where the return comes from.

WORKED EXAMPLE: FUNDING A PURCHASE WITH A SELLER NOTE, ROLLOVER AND AN EARN-OUT

A fund buys Brackley Components, an invented company with EBITDA of 4.0 million, at a headline price of 6.5 times (26.0 million). Of this, 22.0 million is paid at completion and 4.0 million is an earn-out paid later if profit targets are met. Fees are 1.0 million. At completion the funding is senior debt of 2.5 times EBITDA, a seller note of 2.0 million and founder rollover of 3.0 million; the sponsor provides the rest. Find the sponsor cheque, the ownership split and the effective multiple if the earn-out is not earned.

Answer: The sponsor invests 8.0 million for 72.7% of the equity, and the price falls to 5.5 times EBITDA if the earn-out is not earned.

> **Interview tip:** Keep upfront price, contingent price and fees separate before filling the sources. The interviewer listens for whether you treat the earn-out as a later payment, not as part of the cheque at completion.

INT.LM.2.b · Financing and diligence

Carry out diligence on a thinly documented lower middle market business, including quality of earnings and owner add-backs, customer concentration, founder dependence and working capital seasonality.

In a business run by its owner, reported profit is not the same as the profit a buyer will inherit. A quality of earnings review, usually by an accounting firm, rebuilds EBITDA from the ledger and bank records and adjusts it to a maintainable level. Owner add-backs add back costs that will stop after completion, such as personal expenses, a family member on the payroll with no role, or a genuine one-off legal cost. Adjustments also go the other way: the founder may take a low salary, so a replacement manager at market cost reduces EBITDA, and rent paid to an owner-controlled property may be below market. Each add-back needs evidence, and costs that recur every year are not one-offs. Customer concentration matters because losing one large customer can remove a large share of profit, so the review measures the contribution margin on that revenue, the length and terms of contracts and the customer's own view, often by a call. Founder dependence is tested by asking who holds the relationships, the pricing knowledge and the technical expertise, and whether the team can run without the owner. It is handled by structure: rollover equity, a deferred or contingent part of the price, a handover plan and the hire of a second

layer of management. Working capital can swing through the year, so the agreed normal level, or peg, should reflect the seasonality at the date of completion. Counsel handles the contract wording. Interview point: say what you would adjust, what you would test and how you would price what you cannot remove.

WORKED EXAMPLE: FROM REPORTED PROFIT TO A PRICE, AND WHAT ONE CUSTOMER IS WORTH

Dunmore Fabrication is an invented founder-owned manufacturer with revenue of 18.0 million and reported EBITDA of 3.60 million. The review accepts add-backs of 0.30 million of owner personal costs and 0.20 million of a genuine one-off legal cost. It deducts 0.35 million for the cost of a market-rate chief executive to replace the founder, and 0.10 million for rent paid below market to the founder's property company. The largest customer is 30% of revenue and earns a 35% contribution margin. At 6.0 times, what is the price and how much profit rides on that customer?

Answer: Adjusted EBITDA is 3.65 million, giving 21.9 million at 6.0 times, and about 52% of that profit depends on one customer, so part of the price should be contingent on keeping it.

Interview tip: Show adjustments in both directions and put a number on the concentration. The interviewer listens for whether you adjust for the cost of replacing the founder as well as for add-backs.

INT.LM.3.a · Value creation, exits and returns

Explain how a sponsor professionalises a founder-led business and how a buy-and-build platform works, including multiple arbitrage, its limits and integration.

In this segment the central source of value is often turning a founder-led business into an institutional one. That means a finance function that produces timely monthly accounts and a budget, reporting on a small set of operating measures, a second layer of managers so the company does not depend on one person, systems for finance, customer and operations data, and governance through a board with regular meetings and an independent voice. A finance director is often the first hire, because every other improvement depends on reliable numbers. Professionalisation also reduces the risks a buyer would price at exit, which is why it can raise the multiple as well as the earnings. A buy-and-build strategy takes a platform company and adds smaller acquisitions. Multiple arbitrage arises because small add-ons are bought at lower multiples than a larger platform is valued at, so each pound of acquired EBITDA is worth more inside the platform. It has limits. A buyer at exit pays the higher multiple only if the combined business is genuinely larger, integrated and stable, not a loose collection of companies. Competition for add-ons raises their prices, integration costs money and management time, key people at the acquired firms may leave, and the platform's own multiple may not rise. Acquisitions should be paced to the platform's capacity to integrate. Interview point: show arithmetic with integration costs and say what must be true for the platform to earn the higher multiple.

WORKED EXAMPLE: WHAT BUY-AND-BUILD IS WORTH, AND WHAT IT NEEDS

A fund buys Wexcombe Services, an invented platform with EBITDA of 4.0 million, at 6.5 times (26.0 million). Over three years it buys three add-ons with combined EBITDA of 2.0 million at 4.0 times (8.0 million) and spends 1.0 million integrating them. At exit the combined EBITDA of 6.0 million is sold at 7.5 times (45.0 million). Ignoring growth, cash flow and debt, what was the gain, where did it come from, and what is the risk?

Answer: The gain is 10.0 million: 7.0 million from add-on arbitrage and 4.0 million from the platform's re-rating, less 1.0 million of integration. It depends on the combined business earning a higher multiple, and falls to 4.0 million at 6.5 times.

Interview tip: Always take integration costs off, then show what happens if the exit multiple does not rise. The interviewer listens for whether you know arbitrage only works if a buyer pays for scale.

INT.LM.3.b · Value creation, exits and returns

Describe lower middle market exit routes and the step-up in size and multiple expected at exit, and work out segment returns from growth, margin, multiple and limited leverage.

A lower middle market fund usually earns its return by selling a company that is larger and better run than the one it bought. The main routes are a sale to a larger sponsor, which can see a platform that is ready for the next stage; a sale to a strategic buyer, an operating company that may pay more because of savings and strategic fit; and a recapitalisation, in which new debt or a new investor returns part of the fund's money while it keeps a stake. The step-up is the idea that a larger, more professional business with a deeper team and cleaner reporting is worth a higher multiple than the founder-led business that was bought, partly because bigger buyers can reach it and partly because it carries less risk. Underwrite it with care: a conservative plan assumes an exit multiple at or near the entry multiple and treats a step-up as upside. Because the debt capacity is limited, return in this segment comes more from EBITDA growth through revenue and margin, from the multiple,

and from add-ons, and less from leverage. The return arithmetic is the usual one: equity value at exit less equity invested, divided by equity invested for the multiple, with the gain split into EBITDA growth, change in the multiple and net debt paid down. An earn-out is extra capital invested later, so it raises the cost basis. Interview point: say how the gain divides and how much of it depends on the exit multiple.

WORKED EXAMPLE: COMPARING EXIT ROUTES FOR A PROFESSIONALISED PLATFORM

A fund invested 10.5 million of equity in Hartley Controls, an invented company, and owns all of it for simplicity. At exit EBITDA is 6.0 million and net debt is 4.0 million. A larger sponsor offers 8.0 times, a strategic buyer 9.0 times. Alternatively a recapitalisation raises total debt to 2.5 times EBITDA and distributes the new borrowing. Compare the three for the fund.

Answer: A sponsor sale gives 4.19 times, a strategic sale 4.76 times, and a recapitalisation returns 1.05 times of cost while the fund keeps its stake.

> **Interview tip:** Compare routes on what the fund receives and what it keeps. The interviewer listens for whether you see that a recapitalisation is not an exit but a partial return of capital.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.