DEALFLOW

Standing out from the crowd

With increasing dry powder and strong competition from strategic buyers pushing asset prices higher and higher, it's more important than ever that mid-market firms differentiate themselves, explains Baker McKenzie's Michael Fieweger

***Fieweger:** mid-market funds are more diverse*

In the first half of this year, buyers were paying 9.9x EBITDA for US mid-market businesses, and of that 5.3x was debt. This compares with 9.6x EBITDA in 2016, which was evenly split between debt and equity.

These high valuations are challenging private equity fund managers to refine their investment theses and find unique angles on particular transactions to deliver the returns their LPs are expecting, says Baker McKenzie partner Michael Fieweger.

Q What have deal volumes in the mid-market been like in the last 12 months?

It's not quite as strong as the prior year but dealflow has continued to be strong. There are still quite a few secondary trades in the market and a steady flow of corporate divestitures and carve-outs.

That said, demand is still outstripping supply with good assets difficult to find. A lot of sponsors fared well with the assets they acquired on the back side of the financial crisis in 2010-12. Much of that inventory has washed through the system in 2014-16, so there are fewer good assets available on the secondary market.

We continue to see strong competition for the assets that are available. There are certainly a lot of private equity funds who have raised significant capital chasing the same assets. There is also a lot of cash at corporates who are chasing these deals. Strategics, buoyed by strong profits but a lack of organic growth, are inclined to pay up for growth via M&A – seeking to consolidate positions in slower growing industries. That challenges private equity sponsors to find angles on transactions that will allow them to pay a higher multiple and still be able to produce the types of returns their LPs expect.

Q Has the competitor set changed?

When mid-market funds are chasing deals right now, their biggest competition is strategics, and, of course, other private equity firms. Strategics, with their cost of capital and cash available these days, are tough to beat out if they really want the deal.

But there are entrants from different countries too. Recently we were sellside on a higher mid-market transaction for a fairly global asset. Approximately 35 percent of the bids that came in were from Chinese bidders, and of those 90 percent were Chinese private equity in one way, shape or form. That was an asset that had a certain amount of China exposure, but that said, there are pockets of money coming from all over the world that can suddenly start playing in these spaces; it isn't just the people in their own backyard. People are willing to go further afield to do a deal if they think it makes sense within their investment thesis.

Q Are larger managers looking to the mid-market for buy-and-build opportunities?

Buy-and-build is certainly a tried and true private equity investment model, and it's even more important today. If you've got to pay up for the platform, you need to be able to identify add-ons that fit within the higher price that you've paid. There has to be a bigger thesis beyond just buying that business and expecting it to continue to somehow produce growth internally to justify the higher multiple.

Whether it's the big guys coming down or the mid-market guys growing up, I think it's all a matter of whether somebody has an investment thesis that makes sense. For the big guys it's not going to make sense to go too far down unless they're looking at

> ***There's a lot more focus on operational diligence right now, there's a lot more focus on the investment thesis, and really drilling down***

something where they see a big roll-up play where they can put a lot of capital to work. I think also they're coming down because they've got a lot of money to put to work. You can't just wait around for the big deals, because everybody's raised a big fund lately.

Q Where does the mid-market fit into LPs' portfolios?

It's diversification. The big investors are in a lot of the big funds already. You're seeing a lot of the large funds club together to take on transactions, which are of a size where they suddenly start to look more like what these investors have in their publicly traded securities portfolios. They're taking private huge public companies. That's a very different investment model than investing in building and growing a mid-market company.

When you're investing in mid-market funds you're getting access to a more diverse set of transactions. It's a different type risk that the LP's taking than with the mega transactions. It's not necessarily more or less risky, but it's non-correlative.

LPs have been allocating more to the private equity asset class and want access to managers of all types. While the mega funds have been raising massive new funds, mid-market managers have been quite successful in fundraising as well. LPs are looking for more industry focus on the part of mid-market managers as deep industry knowledge is seen as necessary to produce returns in the current market. With mid-market managers, it is very much about the reputation and focus of the individual managers – not as much about the "brand".

Q How are managers trying to achieve the same returns in a high valuation environment?

I think if you talk to someone who's a good manager they'll say, 'You shouldn't expect lower returns, you should expect us to do more on the way in'. There's a lot more focus on operational diligence right now, there's a lot more focus on the investment thesis, and really drilling down and saying 'here's what I add to that deal that will allow me to pay more for that', whether that's through sector knowledge or identification of add-ons or an ability to pay more money through the natural play of leverage, which was the way the industry worked in the mid-noughties.

Q How are PE firms looking to differentiate themselves to management teams?

It's identifying your investment thesis within certain industries, and spending a lot of time making connections with people in potential targets long before these assets go on the market. While having early discussions with potential targets won't keep the asset from going through an auction, knowledge of the asset will help differentiate your bid and allow you to identify hidden value that may not be seen by other bidders. Having dialogues, knowing all the folks in the industry, having a reputation of being a good partner for management and someone you can work with is very important.

Q What are sellers looking for in a private equity buyer?

Sellers today know what kind of numbers they're going to get, so they want to make sure that it's still a successful deal that gives them the least headaches.

If it's a family-owned business that's going to transition, the sellers are often very interested, often in an almost paternalistic manner, about the welfare of management teams, employees and their business. Being able to form personal bonds with sellers, management teams and the employees is critical to succeeding in acquiring family-owned businesses.

If the target is being divested by a large corporate, the seller is interested in ease of transaction. They want a buyer who understands what it will take to operate that business and has the ability to work with or supplement management to help the business succeed on its own. Quite often there's a lot of interdependency in the business that's going to be carved out with the seller's business and as such a smooth relationship after the acquisition is important.

Q What is the biggest challenge for the US mid-market in the next 12 months?

The biggest challenge remains valuation. There's just so much capital available right now that prices are continuing to be pushed up. Finding a way to differentiate yourselves from every other private equity fund and strategics continues to be the number one challenge that private equity fund managers face. ■

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