THE US MID-MARKET

The new ways to find value

As asset prices continue to soar, private equity houses are joining forces with strategic partners to make the numbers work in America, say Baker McKenzie's Mike Fieweger and Nick Marchica

With dry powder reaching as much as $1 trillion globally and competition for deals on the rise, mid-market US players are coming up with new ways to find value in a market commanding high prices. Tie-ups between private equity and strategic buyers are increasing and there is growing interest in more complex transactions, such as corporate carve-outs. We spoke to Mike Fieweger, chair of Baker McKenzie's North America private equity practice group, and Nick Marchica, a partner in the firm's New York office and member of the firm's North America private equity steering committee, to examine how these trends are playing out in the US mid-market.

Q How would you characterise the US mid-market currently?

Mike Fieweger: The M&A market remains strong across the board and so it is very difficult for private equity houses to find deals at attractive valuations. High profits and cash positions at strategics are pushing up valuations and the incentives to repatriate cash through tax reform is adding fuel to the valuation fire in the US. We've had such a run of M&A over the last few years that we're now starting to see some softness in the assets available in the market – many of the highest quality assets have already changed hands and so the inventory is not as strong as it was. So, with continued high valuations, private equity houses are moving towards different strategies to win deals and mitigate the longer holding periods that will be required to create value in the companies they back.

> *Exit timing and the sales process is clearly one area for potential conflict and a corporate must understand private equity's need for liquidity*
>
> Mike Fieweger

Q And this is leading to some new partnerships, isn't it?

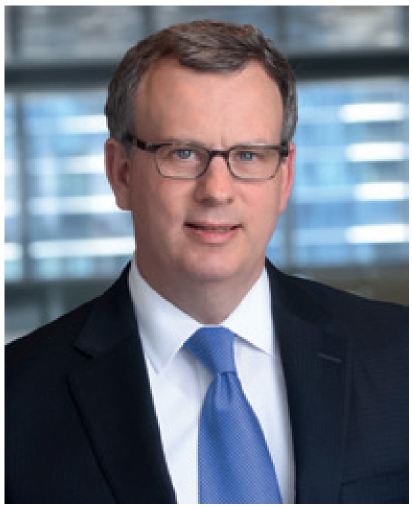
Nick Marchica: Yes. The trends Mike has just mentioned are driving private equity shops to pair up with strategics more frequently than we've seen before. We've been involved in a lot of deals on both the sell- and buy-side over recent times where this has been a feature.

These partnerships are designed to help both sides reach higher valuations and assist private equity with some of the heavy lifting with integration required following the deal. It's enabling private equity to target deals they might not otherwise do without their partners' deep pockets and strategic capabilities.

Q Isn't it also about de-risking?

MF: Yes, to a degree. Private equity firms obviously don't want to put all their eggs in one basket and partnering with a corporate buyer enables firms to gain the benefits from a strategic partners' synergies that allow them to pay more for assets. For their part, many strategics are not willing to commit the amount of capital required to win transactions. With valuations so high, it's a way of giving both sides the wherewithal to acquire businesses.

Beyond the deal stage, there can be some significant benefits. The involvement of strategics adds significant operational excellence and, in some cases, synergies. There can be other side benefits, too. We recently worked on a deal where the target lost its CEO. The strategic partner was able to parachute in a high quality replacement to stabilise the company until a proper search could be completed. So even where there might not be obvious synergies, there is expertise across a range of areas that a corporate partner can bring to the table.



Fieweger: *a corporate partner can bring expertise to the table*

Q Corporates and private equity houses usually have quite different objectives when they invest in deals. How can these be managed or even aligned in partnership situations?

NM: One of the biggest sticking points can be around exit horizons. That has to be negotiated and ironed out from the outset. Yet in the deals I've seen, private equity houses haven't been constrained in offering their strategic partner first right of refusal when it comes to selling the business, but they do typically give them an informal first crack at it.

MF: It's incumbent on both sides to flush out any potential issues early on. These issues need to be put on the table, discussed and a path found for how they will be addressed before partners step into the transaction. Exit timing and the sales process is clearly one area for potential conflict and a corporate must understand private equity's need for liquidity and agree to creating incentives for management to get there. The key to creating a mutually beneficial arrangement is to balance the desire of the financial sponsor to build value within the target business with the interests of the strategic partner to obtain synergies and share information from the portfolio company to the parent. As such, issues such as capital expenditure and R&D budgets, management incentive packages, secondment of personnel into the target, sharing of R&D and cross sales of products and services need to be addressed from the outset to ensure the partners are on the same page.

Marchica: exit horizons need to be negotiated from the outset

Q You're also seeing a different type of partnership emerge, aren't you?

NM: Yes. For many of the same reasons we've already discussed, we're increasingly seeing private equity firms join forces with each other by combining portfolio companies to create a larger platform business. Often, these are companies that are not yet ripe for exit or situations where firms are looking to create additional value through further buy-and-build acquisitions. By working together, the firms are also avoiding overpaying for assets as they might in an auction situation.

This type of partnership helps private equity avoid one of the issues we've seen a lot in the market, where firms pay a high price for a business they plan to be a platform company but then struggle to find add-on acquisitions. Clearly, the same kinds of agreement as we've already discussed for strategics need to be in place between private equity firms for this to work.

Q What about carve-outs? Are these still an area of focus for private equity, given the competitive nature of many of the more pre-packaged, cleaner deals?

MF: Carve-outs continue to be a strong focus area for many sponsors because the complexity of the transactions and the need to work cooperatively with the seller create an opportunity to obtain a proprietary transaction outside of the auction process. Private equity firms are a natural owner in many of these situations because they do not pose the competitive concerns that strategic competitors do and they can establish new structures that enable them to more efficiently extract the business from the seller group. Private equity sponsors are spending a lot of time engaging with large corporates to identify deals ahead of a possible sale – and while these deals aren't without risk, they can provide some very interesting opportunities to create value in businesses that have been starved of investment and attention.

Q And finally, how do you expect market conditions to play out over the short to medium term?

NM: There will still be competition for some time to come. Even if interest rates continue to tick up and credit conditions tighten somewhat, debt availability will remain high. There is a lot of dry powder in the market and strategics have strong balance sheets so there will still be robust activity.

MF: I agree the market will remain competitive. I think we'll continue to see buyers trying to pre-empt auctions. Private equity houses are spending a lot of time courting businesses ahead of deals so they can be in a good position to win deals. ■

SPONSORED BY
BAKER MCKENZIE