MERGERS & ACQUISITIONS

Roundtable

Private Equity:
An industry in transition

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There is no question that the private equity industry is currently experiencing a lot of change as macro economic conditions have shifted and investors' appetites continuously change. Traditional private equity funds are no longer the only way to invest in companies. There are all kinds of investment vehicles that are garnering the attention of sellers today. To discuss how investment vehicles have changed, M&A Magazine recently gathered a group of M&A professionals, including lawyers, a family office investor who invests directly in deals, an independent sponsor, a middle market investment banker and two private equity professionals, including one who recently launched a new firm. Hosted by M&A Magazine and sponsored by Benesch, this roundtable offers valuable insight into M&A investment processes today and what lies ahead for deal makers as they look to transact in the future. The following is an excerpted transcript of the discussion.

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> Jim Hill

Danielle Fugazy (Moderator): How you would characterize today's private equity environment?

Jeremy Holland: The market is competitive and we are all seeing specialization, and that's probably representative here today as everybody at this table is specializing both in terms of firm model and structure, as well as industry or stage expertise. It's quite competitive.

Bob Levine: It's a maturing industry—if not mature already—which leads towards that specialization.

Fugazy: There's been an increase in emerging managers, independent sponsors and family offices doing deals directly. How do all the different and new entrants impact deal making?

Marshall Phelps: We are seeing family offices, increasingly sophisticated family offices, participating in nearly every process that we're running. They have realized that they can be competitive. They can appeal to management teams with their ability to hold investments over the long-term. They can be more patient with their investments and are bringing in talent with private equity backgrounds to run operations for them. We see fewer independent sponsors in our processes because they tend to be more active in the lower middle market.

Jim Hill: Family offices and independent sponsors have a huge advantage because management doesn't want to be "flipped" in two to five years as they are not wanting to be controlled by another owner.

Dan Lipson: We're an independent sponsor, but we have transformed ourselves somewhat as we recently structured a multi-year funding arrangement with a large university endowment. This vehicle will gives us more certainty of funding while preserving the aspects of being an independent sponsor that we covet. However, in today's market, family office participants have become more institutionalized, employing teams that are capable to fund their own deals. Yet while they sometimes go direct, they also bring deals to investors like us and fund on a one-off basis, backing us to execute. All of this has brought more market participants, especially to the lower middle market.

ROUNDTABLE PARTICIPANTS:

Danielle Fugazy, Contributing Editor, Mergers & Acquisitions
Jim Hill, Chairman of the private equity practice, Benesch, Friedlander, Coplan & Aronoff LLP
Ira Kaplan, Executive Chairman, Benesch, Friedlander, Coplan & Aronoff LLP
Jeremy Holland, Principal, The Riverside Company
Dan Lipson, Founding Partner, Rotunda Capital
Marshall Phelps, Managing Director, Lazard Middle Market
Bob Levine, Managing Partner, L2 Capital
Jordan Katz, Co-Founder, Angeles Equity Partners

Ira Kaplan: Clearly family offices are robust players in the market. They're absorbing inventory that otherwise could go to private equity firms. When you sit with investment bankers, when you're counseling a client on how to take their business to market, there's another very viable alternative of possible investors that are at the virtual table today. The same is true of independent sponsors. Further, to the extent that there is proprietary deal flow, they also are absorbing some of that deal flow, which comes to them in part through their own networks including with other similar investors.

Holland: People forget where a lot of today's private equity firms came from. Riverside was an independent sponsor at the beginning. Twenty-eight years later and $5 plus billion under management, everyone's lost sight of how we all started. I think it's important to have an appreciation for the genesis of new firms. And some of our best deals have come in partnership with independent sponsors.

Jordan Katz: That's an interesting point. Fifteen years ago the lower middle market was dominated by the name brand firms that we all know today. As they have became more successful, their funds doubled, tripled and quadrupled in size. And so the lower middle market has largely been vacated by these firms and created opportunity for spinout funds, independent sponsors and family offices.

Bob Levine: The same thing happened in the 1980s. The firms that were middle market firms then are now multi-billion dollar funds today. It's very difficult to say no to a lot more money. Firms like Marshall's have moved up market with those firms. It's just an evolution.

Lipson: All these entrants have definitely affected the market and trickled down to the lower middle market. We go to talk to a platform company that might be doing $4 million to $6 million of Ebitda. Most traditional mid-market buyers wouldn't look at this as a platform, but it might be a very compelling add-on acquisition for a $20 million Ebitda mid-market company. Since multiples have risen in the mid-market that raises multiples for those add-ons and therefore affects the lower mid-market.

Phelps: Part of the way the funds are justifying bigger prices these days is through add-ons. You buy the platform at 10 times; you buy the add-ons at six times. You're leveraging down your multiple. There's a huge amount of focus on this in the middle market, from platform and to add-on acquisitions.

Fugazy: Do the new entrants have the infrastructure to compete effectively?

Hill: Many don't have the infrastructure. Some family offices do, but many do not. Multi-family offices get together and create somewhat of the infrastructure needed. The McNally family has the infrastructure with several funds in Chicago.

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> Bob Levine

Levine: Part of the reason I left a bigger firm was because of the infrastructure and the regulation. It took a lot of the fun out of the business, dealing with the government, the regulators, the increasing limited partner requests for information, reporting requirements, and having to conform to what are deemed to be best practices at the moment. All of that stuff was increasingly less fun. I got into private equity to work with entrepreneurs to help build businesses. I'm doing that again and I don't have to deal with these issues.

Lipson: We talk about the infrastructure part a lot. There's no way we could do the velocity of deals that Riverside could do. But one of the things that we always discuss with prospective management teams is that these larger firms are caught in the cycle of constantly putting out money and raising money. We aren't subject to those same constraints. Therefore with us you get greater partner attention, more focus on the management partnership and similar operating resources. A lot of our operating partners have worked with the larger firms. The partnership approach is what a lot of these family-owned, founder-owned businesses, are looking for. They want strategic advice. You get a lot more of that with us than you would with a larger firm.

Holland: I can't help but argue that we have the best of both worlds. While it is a large firm that can offer global sourcing strategies, add-on acquisitions, counsel that can help with multi-national deals, it's still a small deal team working with any specific portfolio company. With us you have one operating partner on the board and one deal partner on the board that are going to live with that portfolio company all the way through.

There are pros and cons to any model. Our depth of resources is exactly what's allowed us to expand to six different strategies. The individuals that have recently joined Riverside to lead our new strategies had many options. They chose to work under the Riverside umbrella. Our unique resources, operating expertise, origination team, fundraising capabilities, and other differentiators allow them to do more, faster. They can focus on what they do best, which is making great investments.

Katz: Before my partner Tim and I started fundraising, we spent considerable time building out our infrastructure and our back office, such that when we formally entered the market, we believed we were already institutional-quality. We interviewed five compliance firms and as many fund administrators, and then the audit and tax teams. We spent significant time understanding the various issues and determined who we thought would be the right partner for us and for our new firm. I think that effort made a big difference with our first closing investors. When they looked at us, they looked at a firm that had prioritized issues that are important to an institutional investor from a back office perspective and we continue to go through back office or operational due diligence evaluations by prospective investors.

Yes, you have to have good deal people and good ops people and good business development professionals, but you also need to have somebody or some effort that's focused on the infrastructure, compliance and back-office of the firm.

Levine: The bottom line is that the overhang of regulation and compliance is unlikely to get less as we move forward. It tends to become fixed overhead. The terms that are able to be garnered by the funds tend to be less lucrative. And because of the "law of big numbers", the ability to earn the amount of money or have the upside for people in the industry will consequently, squeeze out smaller firms.

Hill: I agree. Compliance is really key and many PE funds use outsourced compliance firms.

Fugazy: What are LPs looking for today?

Katz: I believe they are looking for focus, specialization and a commitment to a specific place in the market: whether that's deal size, industry or operational complexity. The LPs are looking to understand why your strategy is distinctive and how you can generate outsized returns through cycles. They are increasingly looking to build a portfolio consisting of specialized investment strategies where they believe they might be underweight. As a firm, you need to tell a concise, distinct story with some experience that points to your ability to outperform in that niche.

Holland: LPs are seeking specialization. Many people comment on how much Riverside has grown. But, our differentiation is actually that

we remained the same. We remain specialists in the lower middle market, while other successful firms moved up to significantly larger deals. LPs focus on our differentiation and specializations. So, whether it is the scores of healthcare deals, our franchising practice, or our knowledge in software or other niches where we excel, they appreciate and understand that our industry specialization is differentiation.

Phelps: The increased specialization that you see is amazing. For example, we know funds focused specifically on information and analytical tools companies, funds focused solely on tech-enabled outsourcing companies, etc. When you ask them if there's enough flow for their focus, they'll tell you that there is.

Another example is in the sports sector, where Lazard spends a lot of time. The sports industry is truly international at this point, and there are a number of sports-focused investment funds that have emerged — not to buy sports teams per se, but to buy assets in and around the sports sector. You wonder, is it possible to generate enough flow? And the answer is yes, given the international aspects of the industry and its continuing importance to fans, broadcasters and sponsors.

It goes to the overall sophistication and institutionalization of the middle market. There are specialized niches that are flourishing.

Lipson: To that point a lot of the sell side advisers expect you to have industry knowledge. They expect you to have an operating partner. They expect you to even have prior knowledge of the company before the book actually comes out.

Phelps: We think, 'If there's a new opportunity that comes our way and we've never heard of that company before, that's not ideal for us.' And I think the same is true for sponsors. You want to be in touch with advisers to say, 'Hey, this is a great asset. Let us know, when do you think it's coming to market? We've done some ground work in the space.' So you're introducing your own capabilities to the sell side adviser.

You may get cut off the list if you're not in touch with the banker to say, 'Hey, if you're only going to 50 sponsors or 25 sponsors, you could put us on the list because of X, Y and Z.'

Holland: We are seeing intermediaries doing a first, quiet process with just a handful of firms that have the depth and specialization in the particular industry, whether it be healthcare deals or education or whatever. Their view is that if you have the top five or 10 buyers in that niche, they can create enough competition to clear the market. And if those firms don't step up quickly to a high valuation, then they'll go out more broadly to the dozens of buyers that they consider to be in the next tier.

Hill: When I started in private equity in Chicago in 1970 with Carl Thoma and Bruce Rauner, there was no venture capital, no real estate, no oil and gas firms. Firms today firms need a niche.

Fugazy: With a new crop of emerging managers out there, can they all be successful?

Katz: I wish I knew exactly what it took to be successful. Clearly not all the emerging manager funds will be successful in raising committed capital. From my vantage point, I will say there most definitely seems to be a bifurcation between those groups that are able to enter the market, create significant momentum early on in their fundraising and get out of the market at a target amount in about nine months, and then other firms that struggle their way through it and can't get it done. Oftentimes the ones that struggles are people who came together in a new format and that don't have a track record investing together. They don't have the consistency of working on deals together. I think LPs spend a lot of time thinking about the dynamics of a first time fund and whether or not that team can actually work together over time. Can they execute their strategy? Will they be together in 15 years? As we know, these are 10-plus year partnerships. And so there's a lot of focus on that aspect of it, which goes well beyond the math of a track record or a pedigree from a prior firm.

I would add that timing matters. It can depend on what people think the economy is going to look like in the next one year, three years, five years, what existing managers they have and how the re-ups look. And there are different strategies that certainly resonate with different LPs for different reasons at different times, some of which aren't visible to the market.

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Fugazy: While there are benefits to being independent, why did Rotunda decide to take a portion of permanent backing now?

Lipson: We've been an independent sponsor for quite some time. We found that we had a lot of success in that model, the money part really wasn't the issue. We discussed raising a fund, but the time that it would take—12 to 18 months at a minimum, full-time—to raise a fund would be pretty significant. That's time we could not be sourcing and closing deals. We decided just to continue with our path, but we were still faced with the issue that in a downturn of the economy, family office money might not be there if it wasn't committed in advance. It also hard to hire a junior staff when your income level fluctuates so massively because you have no GP level income outside of portfolio management fees. So we decided that there had to be some version of a hybrid vehicle and entered an agreement to work with a university endowment in order to achieve such.

Hill: I understand Dan's reasoning for taking money, but less family offices are willing to invest this way today. Family offices want to invest in companies directly instead of a blind pool. That's a fact of life today.

Fugazy: How do independents or family offices deal with the tough competitive environment?

Levine: One of our major investment themes is that we're looking for businesses that can be successful even in down markets. That's one of the criteria we seek in our companies. The other thing is we have different investment parameters. We're not seeking to be a top quartile anything. The way I look at it is there's a certain type of return we're seeking for our transactions. If we don't see an opportunity to get those kinds of returns in the transaction, we'll invest somewhere else because we have an allocated portfolio like anyone else. It takes a lot for us to give up liquidity. If our goal is to get a certain minimum return on a private equity deal and we can't, we'd rather invest in something else. So we have flexibility in that way. We don't have to put money out.

Fugazy: Are there any proprietary deals out there?

Holland: There absolutely are. You see it frequently in our portfolio with the add-on acquisitions where our origination team can get out there and help find those entrepreneurial businesses that fit well with our platform companies.

When defined as purely a one-on-one relationship, I'd say our firm is closing more than a dozen of them a year, year in and year out, and largely through add-on acquisitions.

Lipson: It happens more on the lower middle market.

Phelps: Or at the super-high end of the market. There are business owners that say the only buyer for my business is Warren Buffet, for example. In the core middle market where we operate, proprietary deals are increasingly rare.

Lipson: In the lower middle-market you find sellers who are really looking for a partner. They might be a founder of family-owned business looking to not only diversify their net worth away from their primary business, but also to capture a strategic opportunity or consolidation opportunity. If you happen to have been calling on them for quite some time, getting to know them and their business, they'll ignore all the other calls. But, trust me, brokers, bankers, private firms, a lot of people are calling them.

Kaplan: If you are a strategic buyer of some size and have done deals, the likelihood is that you're known in the marketplace and deals will find you. And sometimes they're referred by guys like us. And there is a world of very good buy-side investment bankers out there to the extent that funds or family offices are interested in utilizing their services and are willing to pay a retainer. We have worked successfully with any number of them in finding non-shopped deals.

Katz: Proprietary deals do exist. We were fortunate enough to be able to get our second deal done on a proprietary basis, but it took 20 months. It was about relationship building with a management team that eventually realized that selling a stake now, bringing us in as partners to add value to the business, would ultimately maximize their own value when we go and exit the business collectively. That was calculus that took

a while for them to understand, but nevertheless, once it does become clear to a management team or a seller, these opportunities are possible. There's no question they do take a long time and significant effort to cultivate.

Levine: Proprietary deals make the cycle a lot longer. One of the advantages of participating in processes is that you have a willing seller. In a proprietary process, you have to convince someone that they are a seller. That takes time.

Fugazy: Sell side due diligence has become a hot topic. Why?

Phelps: In Europe it's par for the course. It's become increasingly prominent in the U.S. as you move up the market. At a minimum, we recommend that any sell side process involve a quality of earnings review. That's pretty standard now. I don't think anybody is going to be surprised by that. The question becomes are there other elements you might build around the quality of earnings review? Are there specific environmental issues, litigation matters, etc.? If there are certain known issues with the business, do you want to get out in front of it with respect to how you're going to approach the buyer community?

In the U.S., you're not seeing the full sell-side due diligence package that the Europeans typically offer. I don't think you're going to see that change dramatically, mostly because private equity funds and strategic buyers here prefer to do their own diligence on a number of these issues and they're not comfortable relying on the seller's review of the matter.

Kaplan: We see it all the time, especially as deals get larger and buyers and sellers are more sophisticated. It is market these days for sellers to do their own quality of earnings reports and to come to the table armed with their own environmental reports if the seller is a manufacturer, for example. In that way, they can understand and be prepared for challenges to the adjustments to Ebitda that a buyer would raise. On the environmental side, the seller can better define and control the scope of a buyer's environmental diligence and also understand where any risks exist and develop a plan to address those risks. This allows our seller clients to get ahead of these matters.

Holland: We've even had a great deal of success with it because we use it to illustrate, in detail, the difference between the organic growth and the add-on growth so that buyers don't assume that all the growth was all through add-ons because we may have completed several during our hold period. We view it as a complement to the buyer's work. But we recognize, as a buyer ourselves, that the buyers only have so many hours in the day and they have to choose which deals to work on. If we can make it easier for them and clearer for them to see how they're going to get to the finish line, then they're more likely to continue participating in our process as opposed to another.

Hill: We have a very thorough checklist with all of our PE clients and then we cover the seller representing the buyer. Quality of earnings, if done by the seller, is appropriate but the seller opens himself up to be attacked on the financial statements.

Phelps: That's a great point. We've seen situations where we know it's going to be a frothy process. The multiple is going to be significant. And the seller will ask us, 'Why am I going to spend $100,000+ on a quality of earnings review, if my financials are clean?' but it makes the process much smoother if the buyers can see the financials in that light. And the seller has the added benefit of being armed for any surprises.

Katz: I find value when a seller and their advisers have an honest assessment of the business and the financials and actually have gone through the steps prior to soliciting indications of interest. We see situations often, particularly in the lower middle market, where half of the Ebitda number is adjusted. Ultimately, that is unlikely to hold up to a quality of earnings review. The problem arises when the expectations have previously been set by advisers, and in the seller's head, that they're going to get a multiple on that Ebitda. And when that Ebitda is found to be 50, 60, 70 percent, it creates a problem for the process. And so I find there to be value, because everyone is on the same page early on, related to a key valuation metric. ■

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