MERGERS & ACQUISITIONS | Roundtable

Lower middle market keeps up busy pace

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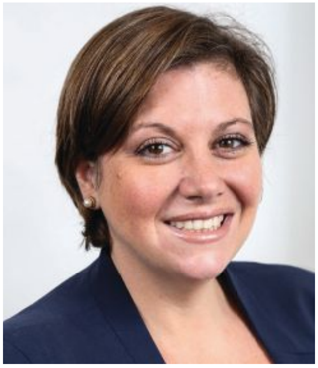

MODERATOR

Danielle Fugazy
Contributing Editor, *M&A*

As the M&A industry continues to experience very competitive market conditions private equity firms transacting in the lower middle market are looking for ways to win deals without over paying. And of course they are then looking to add value to these companies and sell them as stronger, more profitable companies. But with highly competitive market conditions is this possible? What lies ahead for professionals transacting in the lower middle market and how can they create success? Mergers & Acquisitions hosted a roundtable to explore what's going on in the lower middle market of the private equity industry, how these firms are creating value and what's in store going foward. The event was sponsored by Abacus Finance. What follows is an excerpted version of the conversation.

PARTICIPANTS:

Danielle Fugazy, Contributing Editor, *M&A* Magazine

Peter Calamari, Managing Director at Platte River Equity

Andy Levison, Managing Partner at Southfield Capital

Sean McKeever, Managing Director and COO, Abacus Finance

Sean Roberts, Principal at Huron Capital Partners

Mark Sullivan, Partner at Lineage Capital

Danielle Fugazy (moderator): How would you characterize market conditions today?

Sean McKeever (Abacus Finance): There has been a lot of capital raised by private equity firms which has increased demand for assets and put pressure on purchase prices. However, the same could be said for the private debt market, which has resulted in an accommodative financing environment for private equity back issuers.

"A lot of our private equity clients are doing add-on acquisitions at lower entry multiples than the initial platform purchase which averages down the entry multiple."

Sean McKeever, Managing Director and COO, Abacus Finance

Andy Levison (Southfield Capital): We're seeing higher valuations, particularly in the bigger companies. It's a more competitive market and it is more important than ever before to have an edge going into the process of acquiring a company; you need to bring something to the table to differentiate yourself and that management appreciates.

Sean Roberts (Huron Capital): You always have to have some degree of an edge; not only to differentiate yourselves to win, but if are you willing to be the highest bidder, you have to bring some value to the table to justify the price that you just paid.

Fugazy: Do you anticipate the market remaining competitive throughout 2017? How do you differeniate yourselves?

Peter Calamari (Platte River Equity): Moving quickly through diligence and having committed financing is almost the ante to even play now. If you are going to pay a higher price, you have to be able to grow the business and demonstrate that you are able to do that to the management team.

Levison: There are a few ways of differentiating yourself. No. 1 is to avoid a process. If you're able to source deals through non-traditional methods and negotiate directly with the owners, that's a significant edge. No. 2, industry expertise. We focus on entrepreneur management owners. We've got a long history of success of doing that. We've got a lot of great management teams, prior management teams that speak highly of us, and that helps a lot in our discussions with the new teams we're focusing on.

Roberts: Every firm is capable of writing a big check. So you've got to bring something to the table beyond just capital. For us, the focus is on situations where we've got an operator who can come in and add value to that business, or a Huron operating partner to sit on a board to provide strategic insight and do things the owner wouldn't be able to do on their own like find that add-on acquisition. Doing those sorts of things is what helps to distinguish us with business owners.

McKeever: A lot of our private equity clients are doing add-on acquisitions at lower entry multiples than the initial platform purchase which averages down the entry multiple. In 2016, 60% percent of all private equity M&A transactions were add-ons.

Levison: There are a number of factors you have no control over—the economy, interest rates, excetra—so whatever you can do to make accretive acquisitions to lower your entry price is critical.

Calamari: We focus on add-ons as well, but we found there is not always certainty around getting them completed. As a result, we spend most of our time figuring out how to drive revenue growth organically. How do we find new products to launch or new services or geographies to get into? How do we add capital to the business to expand the capacity?

Mark Sullivan (Lineage Capital): We are very focused on trying to discern the specific needs of the seller because we are only working with owner-managed businesses. We are trying to sell a transition that's different than a control transaction so we are very focused on understanding what's driving the seller's motivation now and then going forward.

Fugazy: Do your firms have institutionalized value creation plans they are using with each company or is it different for each company?

Mark Sullivan (Lineage Capital): We have a process, but it may result in a different plan. For example, some businesses might be well suited to do acquisitions, for others we may be looking at geographic expansion. We have a process that we take the company through before we invest, and execute on after we invest.

Levison: However you go about creating value, if you don't have management on board to do it, it's not going to work. You have to make sure that there is complete alignment and agreement prior to closing the deal. This should happen during the LOI stage. If there isn't a formal process you can get 90 to 120 days from when you sign the LOI to when you close, so you can not only complete your due diligence, but you can work on a business plan collaboratively with management.

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Andy Levison, Managing Partner at Southfield Capital

We like to have line of sight for significant organic growth as well as add-on acquisitions. We are looking to triple the EBITDA of our companies. Sometimes we'll buy companies and EBITDA will drop in year one as we invest in the business for future growth. That's fine because we create value through growth and because we're in it long-term.

Calamari: Our main focus initially is on getting the right people in the right seats, and making sure they have the right incentives. Then we spend time putting in place the right measurement tools and reporting. Only after we have the foundation in place, do we turn our attention to the growth plan and execution.

Roberts: Developing a plan to create value has always been a part of our process for each transaction, and we put a lot of rigor into the numbers. We really try to say: here is the opportunity, here is our probability of success, here is the scope of it, and try to make that a key part of our underwriting so we can take a bullet point list of ideas about how to create value and put some numbers on it to hold ourselves accountable to achieve the growth that we're underwriting at the onset. Growth through acquisition is a key part of the plan to create value in almost every deal we do. The average business owner isn't going to pursue a large acquisition because they don't typically have the skillset and capital to do it, so we know there is opportunity for us to create incremental value through acquisitions. It is obviously really difficult to quantify the impact of unknown future acquisitions, but we do a lot of work upfront to identify the universe of potential targets so we have confidence going in that there is going to be opportunity to expand geographies or add product lines through acquisition.

Fugazy: Will you pass on a deal if you don't see an opportunitiy for an add-on acquisition?

Roberts: I don't think I can say unequivocally no, but almost every instance that I can think of we go into it with the expectation that there will be add-on acquisitions.

Levison: If we are going into a new deak there are no add-on acquisitions out there, we better be really sure about the organic growth avenues. And in the lower middle market purely organic growth in a relatively short time can be rough so it's important we have identified all avenues of growth.

McKeever: Having financed numerous transactions of various sizes over the last 10 plus years, it is generally easier for private equity firms to add value in the lower middle market than it is in the upper middle market or larger corporate space. It is an advantage the folks sitting around this table have compared to the larger funds at a time when the ability to add value to an asset is likely to be the key contributor to investor returns.

Levison: The other thing is we don't like to over-leverage our companies at the acquisition. The maximum we do at closing is approximately three times debt to EBITDA. For most of our companies we are almost always their first institutional investor. They've never borrowed money, other than working capital, so we don't like to over lever.

Calamari: We would agree. When you're putting so much emphasis on growing the business and the investments that you need to make, and the people you need to hire, and the equipment you need to purchase to generate that growth, that strategy, by definition, means you have to be more conservative on leverage.

Fugazy: Lower middle market firms tend to be more conservative when it comes to leverage, would you agree and do you expect that to be the norm?

McKeever: That's right and it's smart, because a lot of times this is the first institutional money that many of these companies have taken and often times there needs to be investments in that business. It could be additions to the C-Suite, investments in technology, a build-out of infrastructure or adding to the sales force. Having the appropriate capital structure that allows you to make these investments is critical to the value creation process. This is how much lower middle market firms operate and it should continue.

Levison: If you are at a low level of leverage at inception and then you implement changes, you can come back for more leverage once you've built a sustainable business. And that business is a different credit than it was on day one.

Fugazy: Are there any particular types of deals getting done in the lower middle market today?

Sullivan: We invest across sectors and it's very competitive everywhere you look.

"In some ways, the competitive market has made us focus more carefully on what we do and how we can do it better."

Peter Calamari, Managing Director at Platte River Equity

Roberts: One thing we've done is look at the smaller end of our scale spectrum to get involved with businesses. Rather than compete for the $20 million EBITDA business with 100 other firms, let's find that slightly smaller business that's a proprietary opportunity. We have had success with what we call our ExecFactor Program, which is the name we have given to the strategy of finding an industry we really like and then finding an executive who we think we can sponsor to employ capital in the market. We will then go find deals together. When you have that executive with you it goes a long way in conveying to that business owner that we can be a really good partner for them.

Calamari: For us it's really focusing on where we have the most industry knowledge. It's where we have the highest conviction that we can drive value in the business, grow revenue and find add-on acquisitions. If we go to a management meeting and we need to go through the industry overview section, that's probably not the company for us.

Fugazy: The industry is moving toward industry expertise. How important is industry expertise in the lower middle market today?

Levison: The LPs aren't very interested in generalist firms nowadays.

Sullivan: We have a very focused approach; although, the industries that we look at are diverse. As you look at the industries, sometimes sellers don't want someone telling them what to do or feel like there's going to be someone that is second-guessing them or telling them what to do. And then in some cases we have lost out on an opportunity because we weren't perceived to have enough industry expertise, even though they liked our approach. In general, industry expertise has become more important than it was five years ago.

Levison: I agree. And I think it specifically relates to the sourcing side because the people you are sourcing deals from are business brokers and if they think you'll look at anything you won't see much.

Fugazy: As a lender, do you find you have to become expert in certain fields?

McKeever: We have found that our best advertising are the deals that we've done. When we advertise the deals that we've done, there is a description on the industry, and we receive calls from folks that are interested in that industry. It is a key contributor of deal flow.

Calamari: Industry knowledge is definitely an advantage on the sourcing side. It helps in diligence. It helps with finding managers once you've acquired the company and with building a value creation plan.

Fugazy: It seems to reason that deregulation is underway. How do you think that impacts private equity transactions in the lower middle market?

Roberts: Politics aside, less regulation is usually a positive for business. So you'd think it would create a good environment for M&A activity and the economy in general. But everybody's waiting for what these changes are going to be and nobody knows what will transpire. While we think less regulation will be positive in the long run, we're in a period of uncertainty right now and uncertainty may create some headwinds for deal activity in the short run.

McKeever: It will be really interesting to see how the year plays out. You have some of the positives of deregulation, a more pro-business tone being taken by the White House and potentially some infrastructure stimulus. On the other side, there is uncertainty surrounding the new administration—specifically relating to taxes. The potential for lower personal or corporate taxes and a lower capital gains tax may cause some sellers to delay going to market this year. This is going to be an interesting story to watch.

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Mark Sullivan, Partner at Lineage Capital

Levison: People are more optimistic than they have been in a long time. I see it at portfolio companies, with management teams and in general. You don't know how it will turn out, but a lot of the current administration's possible policies don't really affect what we do.

Calamari: I would say in general, the lower middle market is relatively better positioned. We'll see what that translates into over time, but there is definitely a sense of optimism at our firm.

Fugazy: What about on the debt side with all these US tax laws changing?

McKeever: One tax that's directly tied to debt is the potential for interest to no longer be deductible for tax purposes. This change by itself would have a negative impact on our borrowers. However, the question is what will the other changes to the tax code be as many of those proposed in the plan the White House is supporting (A Better Plan Forward) would benefit our borrowers including a lower corporate tax rate and the ability to expense CAPEX in the year the expenditure is made. Based on the relatively low leverage displayed in our portfolio and across the lower middle market, the proposed plan would likely be a net benefit. Now, I don't think that's true if you start getting above five times total leverage, but luckily that is not typical of our transactions.

Sullivan: Some of the businesses we look at are potentially impacted by the import tariffs that may be coming. That's now part of the discussion at our table when we are looking at businesses that import a lot from around the world. The dynamic is different than it was six months ago, that's for sure.

Roberts: We have a number of consumer product companies that import from Asia and there is no domestic supplier for those types of products. It's not as if the import tariff will suddenly make us procure those products domestically. It will be an added tax.

Fugazy: Other than being on your radar, are these potential changes having any other impact?

Sullivan: We are doing business as usual. We are talking about some of these things but we are not hesitant to make an investment because of what might happen.

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Sean Roberts, Principal at Huron Capital Partners

Fugazy: Are you seeing more firms change their mandates to be more flexible?

Roberts: We actually just added the capability to do non-control deals, and we've hired a team of people who have spent their entire careers in that space to help us do that. In some cases the seller may be taking chips off the table in a non-control deal, and in other cases they may be looking for capital for growth or acquisitions. There are lots of different scenarios that you can envision. But we think there is a great opportunity to serve the needs of business owners who aren't ready to give up control and we can be flexible to get deals closed.

McKeever: From where we sit, we get to meet and talk to a lot of private equity firms and hear what they're doing and hear how their strategy is changing. People are more open today to altering their strategy, given how competitive the market is.

Sullivan: On average we partner with people who own 40 percent of the business. They want some liquidity, and they believe in the business and they like the idea of a very large second bite of the apple. For the owners it isn't about taking some chips off the table and diversifing their net worth and then getting the big bite. Others are doing this more. This is all a result of the influx in capital in the market. Family offices are investing directly as well. This is the most competitive environment that we've been involved with in my 20 plus years in the industry.

Calamari: In some ways, the competitive market has made us focus more carefully on what we do and how we can do it better. So how do we get better and faster at diligence, and how do we get more institutionalized around value creation, and how do we get smarter on our industries or deal sourcing to find more opportunities. So on the one hand it is a lot more competitive. But on the other hand, I think all of us continue to get better at execution so that we can still generate attractive returns for our investors.

Roberts: People are getting more creative and allocating more resources to finding deals that are not heavily shopped and being shown to the larger firms. For example, we have focused on developing a network of non-traditional deal sources through accountants, attorneys, and financial advisors. We've also spent a lot of time on ExecFactor deals. We will pursue smaller investments in an ExecFactor situation because we know that we're going to find the next add-on acquisition to quickly get the business up to a scale that makes sense for us.

Fugazy: Would you still characterize today as a seller's market?

Sullivan: It's definitely a seller's market.

Levison: When you exit, ideally you'd like a hot market and the company perfectly positioned to sell. That rarely happens. So in a hot market, would you sell something maybe earlier than you would have because there is that opportunity to do it, yes, definitely. I think selling and exiting is much harder than buying, that's the value add. There's an art to it. Anyone with a checkbook can buy a company, but selling it, creating something that buyers want that might be strategic if you get lucky, that's the value, big value.

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