MERGERS & ACQUISITIONS

High prices force private equity firms to retool strategies

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The middle-market model has fallen victim to its own success in some ways over the last few years. As investing in small, growing companies has proven lucrative, more and more players have entered the fray. These days, mid-market private equity firms face competition from bulge bracket PE firms heading downstream, large corporations looking to accelerate growth, fundless sponsors doing one-off deals and family wealth offices bypassing PE firms to invest directly. Fundraising has been robust, which means there's a lot of money chasing the best deals. That, in turn, has driven up prices. To prevail, many PE firms are re-calibrating their approaches, often by lowering expectations for returns, lengthening hold times and accelerating the closing process.

"We've really had to adjust how we run our models if we're in those situations where we know that it's a very high-quality asset and it's in a competitive process," explains Kelly Cornelis, a partner at LaSalle Capital, a Chicago-based middle-market PE firm. The most attractive companies—those with double-digit growth, lots of upside and low customer concentration—are commanding very high valuations.

"People are going to look at the returns a little bit differently; they're going to lower the return hurdles slightly," says Cornelis. "And they know they're going to get a very attractive debt package. We have to understand that's the reality, and if we want to win, we have to look at it that way."

In addition to the high valuations for the attractive targets, sellers are benefiting from more favorable terms: more cash at closings, smaller seller's escrows, faster closings, and more two-step auctions, where potential buyers compete to be named to a short list of bidders.

"There is pressure to be able to close quickly," Cornelis says. "You've got to be ready to go; you've got to have all of your service providers lined up, and they have to be pushed to get things done quickly. It is a challenge. We try to do as much diligence as we can, pre letter-of-intent, so that we're ready to go, and we can make that happen without sacrificing our diligence."

New normal

Middle-market dealmakers and advisers say the high valuations, paired with record-high debt ratios, reflect an abundance of both capital raised from PE investors and debt supplied by non-bank lenders. PE firms are adapting their strategies to compete for targets, focus on growth for their portfolio companies and reorient their investors' expectations. Recent stock market volatility aside, many of the factors driving the high valuations—such as dry powder from new PE investors and recycled PE exits, active lenders, non-PE competitors for deals, transformations of large corporations and historically low interest rates—show few signs of slowing down.

Many private equity firms accept the record-high middle-market deal prices as the new normal, not a crisis, says Beatrice Mitchell, co-founder and managing director of Sperry, Mitchell & Co., a boutique investment bank in New York.

“We’ve seen price expansion; I think people are sort of used to it right now,” Mitchell says. “What private equity firms would have said to me nine months ago was: ‘Gosh, I can’t believe these prices; we’re just not willing to pay.’ Now these same firms are saying to me: ‘Well, we have to pay, or we’re not going to be in business. But it’s okay, because I’m selling a portfolio company, and I’m getting that kind of pricing too.’”

Expect the high middle market deal valuations to continue through 2018, says Peter Lehrman, CEO of Axial, an M&A deal network based in New York. Corporate tax breaks, repatriation of tax revenues to the U.S. from other counties, low interest rates, a strong stock market and accelerating changes in nearly every industry due to technology will all continue to drive mergers and acquisitions activity, Lehrman says.

Plus, the average tenure of companies in the S&P 500 is as short as it has ever been, which shows that a lot of large companies are in danger of becoming irrelevant if they don’t make transformational acquisitions of smaller businesses, he says. “They need to be very active in terms of thinking how do they defend their positions over the next five to 10 years.”

Another factor driving the high middle-market valuations is the number of new, or newly interested, buyers that have the capital and ability to do deals, including family offices making direct purchases, Cornelis says.

“That is certainly having an impact,” she says. “If we do lose out on an opportunity and we find out who (the buyer) was, it’s usually somebody we’ve never heard of, because there’s so many different types of buyers out there. You’re kind of getting it from all sides.”

Also, family offices, because they can afford to take a longer time horizon on their investments than the three- to five-year target of a PE firm, are willing to pay more, which gives them a boost in the current environment, Mitchell says.

“The family office continues to put real pressure on the private equity firms, because they are set up to buy companies that often have a lower hurdle, in terms of what they want as a return,” she says. “If you hold a company 10 years, (a) 12 percent (annual) return is not bad.”

Short of a stock market crash or a drastic reduction in interest rates, Mitchell says, she doesn’t see the high valuations coming down.

“Intuitively, you would have said, gee, something’s got to happen, this is untenable; there’s not enough supply,” Mitchell says. “But deals are getting done; they’re getting done at very high multiples; there are multiple bidders for deals; and at the same time, private equity firms are able to turn around and sell in this market, so you’re seeing a lot of flips between PE firms.”