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Comment & Opinion

How US private equity firms are differentiating themselves from the competition

"The proliferation of private equity capital alongside the rise of other sources of liquidity is forcing funds to differentiate themselves. Business owners now have multiple investors and acquirers from which to choose. To be successful, private equity funds need to be creative in how they identify opportunities, how they communicate the value they can bring to the growth of a business and to be able to execute a deal processes efficiently."

Mark Wilson
Partner,
Catalyst Corporate Finance

Standing out in a private equity crowd

I have recently met with private equity (PE) firms covering the US lower and middle mid-market, first in San Francisco at our international partner conference and then at the Association for Corporate Growth (ACG) InterGrowth conference in Las Vegas, which brought together sponsors with collective firepower of over $160 billion and who are responsible for around four per cent of all PE deals in the US last year.

There are four key observations from these events, which I think are insightful for business owners, investors and acquirers.

1. It is overwhelmingly a seller's market. However, sponsors still feel that 2017 is a good year to be investing in businesses across the US. Whilst many of the partners in funds will accept they are probably in the eighth year of a growth cycle (so conventionally thinking we are at the tail end of that cycle), they see it as having been a steady climb and investments today will still be of a good vintage in terms of the ultimate returns. This implies they expect favourable exit conditions in three to five years from now, or crudely, at the end of President Trump's first term. This can be attributed to a range of factors, especially Trump's deregulation agenda, infrastructure programme and his business owner-friendly tax proposals, as well as the continued low cost of debt.
2. Add-on acquisitions will be a, if not the, cornerstone of sponsors' value creation plans. It is often quoted that they target a tripling of EBITDA over the hold period and in 90 per cent of sponsor investments, acquisitions are used to achieve this. It means that over two thirds of all sponsor M&A involve bolt-on acquisitions by their platform companies. Overseas acquisitions are an increasingly important part of the mix and firms like Catalyst are frequently being asked to identify suitable targets and advise on acquisitions.
3. To increase funds under management, North American mid-market PE groups are adding other investment themes to their mandates such as property, infrastructure and new geographies. Lately, we have seen a number of lower mid-market funds not only investing directly from the US into the UK, but also setting up funds within the country, a trend replicated by European funds. This will inevitably further crowd-out our already well served market of homegrown funds and will stimulate more deal activity.
4. Given the proliferation of PE funds across the US and the record levels of equity capital that has been raised, coupled to a very accommodative debt market, competition amongst funds is at its most intense for 20 years. Over the page are seven trends I have identified which show how funds are trying to differentiate themselves.

Differentiating trends

Avoid processes

Proprietary deal flow is now mission critical. Many funds operate origination teams or work closely with financial advisors to access exclusive, off-market opportunities. Working closely with investment banks in the US on the buy-side is known to reduce materially the entry price and increase deal deliverability.

Structure to the objectives of the vendor

This sounds like common sense, but too many funds submit offers in line with their LP mandates and then regret having invested so much effort in a process which ends in failure. For example, if the vendor wants to retain control but the fund cannot deliver a non-control, minority investment, then they should walk away early because someone else will be able to offer this.

Institutionalise the value creation plan

Focus very early on the value building process. This may be quite additive to management's base business plan. It will invariably include an acquisition strategy, where the sponsor can bring a lot of added value in terms of mapping out the target universe and managing the acquisitions (as well as creating the headroom in the structure to support M&A). Doing acquisitions is critical for lowering the blended entry pricing as add-ons will be done at lower multiples than the platform. Often, sponsor's will now pass on a deal if there are no obvious acquisition opportunities, unless the organic growth plan is very robust and delivers a three-fold uplift in EBITDA in four years.

Bring genuine industry and context experience to bear

LPs are becoming less interested in generalist firms because they recognise success is pivotal on having a specialism. That may be industry expertise and track record, or expertise with an end customer profile.

'ExecFactor' initiatives

To deliver proprietary deal flow, many funds back successful industry veterans to identify platform opportunities and join as chairman or part of the senior management team. This model works best when the fund has significant experience within the sector.

Improve the deal process

Many funds try to accelerate the diligence process to be able to close in less than four weeks from signing of the LOI. It is less common in the US to have a vendor diligence package on which to rely. As such, those without industry expertise will often struggle to be competitive from a timing perspective.

If there is leverage in the deal, then certainty of committed funds being available at closing is an increasingly important differentiator and we are seeing penalty payments built into the LOI (for example, ten per cent of lend) agreed between the lender and the sponsor to help minimise the financing risk.

Be prepared to price high

There is just no getting away from the fact that even with all the above, the simple economics of supply and demand apply. For the best assets, pricing is routinely now at record highs and vendors will be prepared to wait to achieve the returns they now expect if sponsors are not prepared to pay.

Smart advice

Catalyst advises business owners and management teams on:

- Company sales
- Management buy-outs and buy-ins
- Company acquisitions
- Raising private equity capital
- Raising and refinancing debt capital

Global reach

Our international partnership is present in 50 cities worldwide and provides:

- Access to overseas buyers
- Local insight into M&A culture and likely tactics
- Identification of overseas targets and acquisition execution
- International M&A research

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