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NORTH AMERICA

Kreutzer's Take: Hints of a Midmarket Earnings Squeeze

By Laura Kreutzer

Midmarket private-equity firms are awash in capital, thanks to strong demand from limited partners for midmarket funds. But some of the companies the firms back appear to be finding it harder to churn out cash.

Median earnings among private midmarket companies declined by 2.48% during the first two months of the fourth quarter of 2016, despite a 5.33% growth in median revenue among those same companies, according to the most recent Golub Capital Altman Index data. The fourth-quarter decline follows a 0.66% decline in earnings that the index reported for the third quarter of 2016.

The index, which is produced by midmarket specialty lender Golub Capital in collaboration with credit expert Dr. Edward I. Altman, measures median revenue and earnings performance from the data of more than 150 private U.S. companies in Golub Capital's loan portfolio.

Golub manages more than $20 billion in capital across various equity and debt strategies. The firm's midmarket lending group typically provides financing for midmarket, private equity-backed transactions with hold positions of up to $300 million and is an arranger of credit facilities of up to $750 million, according to a news release.

Lawrence Golub, chief executive at Golub Capital, pointed to the restaurant industry as a sector where margins have been hard hit by forces that include increased labor costs, declining foot traffic at shopping malls and lower food costs that encourage more consumers to dine at home. Compressed margins in the restaurant sector contributed to the 2.05% decline in consumer sector earnings in the latest index data. Earnings among health-care companies in the index declined by 2.56%, partly due to pressure on health-care reimbursements.

Earnings compression, if it continues, stands to put more returns pressure on private-equity firms that paid high prices for portfolio companies and would have a "material effect on private-equity midmarket returns," according to Mr. Golub.

"Profits going down 3% may not bust your company, but it makes it harder to [go] from nine-times (earnings before interest, taxes, depreciation and amortization) to 12-times (Ebitda)," Mr. Golub said.

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