MERGERS & ACQUISITIONS | Roundtable

The New Norm?

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Moderator

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Private equity firms and lenders have been substantially expanding their capabilities over the last five to 10 years to make sure they are capturing more of the market. Mergers & Acquisitions hosted a roundtable to explore how private equity firms are changing, why these firms are successful, how it impacts the market and what dealmakers can expect going forward. The event was sponsored by Golub Capital. What follows is an excerpted version of the conversation.

PARTICIPANTS:

Danielle Fugazy, Contributing Editor, *Mergers and Acquisitions*

Pamela Hendrickson, COO & Vice Chairman, Strategic Initiatives, The Riverside Company

Chip Schorr, Senior Managing Director, One Equity Partners

Andrew Steuerman, Head of Middle Market and Late Stage Lending, Golub Capital

Heather Mosbacher Reiner, Director, William Blair & Co.

Danielle Fugazy (moderator): How has the private equity industry changed? What's different today than five or even 10 years ago?

Heather Mosbacher Reiner (William Blair): The private equity industry has grown exponentially. There has been a tremendous amount of capital raised, outpacing M&A activity and creating a highly competitive environment. Multiples are high and a lot of the larger, upper-middle-market, firms are now playing in the true middle market. It is increasingly hard to get deals done at attractive multiples that make sense.

Pam Hendrickson (The Riverside Company): There're 3,000 private equity firms in the United States. The bulk of them work in the middle market. In general, you have a lot more capital chasing fewer deals. Hence, multiples have been very high for the past three or four years. Just the fact that you used the word industry when you were talking about private equity is certainly a change. We are now an industry: we have regulation, we have publications, we have conferences and we have trade organizations. Private equity is a real industry now and it's being challenged by all the things that industries face as they evolve—margin pressure, regulatory pressure and public relations issues.

Andrew Steuerman (Golub Capital): We're seeing the larger private equity firms stratify their investment product base where they have upper, mid, and lower market strategies. They are trying to play to all sizes and they're using their brand and scale to try to gain an advantage over generalist middle market private equity firms. We are seeing this actively play out in our pipeline of deals. This is creating challenges and opportunities for the broader market.

"To continuously improve you need to make investments in the best people and invest in technology and infrastructure."

Andrew Steuerman

Chip Schorr (One Equity Partners): Historically, you used to have a lot of generalist firms. Now people are trying to become more specialized, but some don't have specialization—they talk about it, but they don't have it. In some cases, where firms are trying to become diversified asset managers, the ability to generate deal flow has been lost because they don't have the depth of specialization and those private equity firms are clustered in the auctions. And then, of course, the prices are too high in the auctions. Firms have lost the skill set or they don't have it because they were generalists who didn't develop the specialization and they're not finding ways to create opportunities. So, the opportunities they're seeing are priced too high.

Fugazy: In addition to specialization, what types of things are private equity firms emphasizing now that they weren't 10 years ago?

Schorr: The value creation processes. If you can't add value to your portfolio companies and you don't have a plan for how you're going to create value, then you're lost. In the early days, you could buy something and create value on the buy. Today, there's no owner in America who doesn't know how to price an asset— you can go on Google and find five tools as an entrepreneur that will tell you what your company is worth. So as an investor, you must be able to make that company worth more. If you can't, you're not making any money.

Reiner: That is hard to do now with multiples high and leverage levels not being stretched to the levels they once were. There are firms that historically created value in the financial engineering of the deal. They did not have that specialization in terms of operations and creating value at the business level.

“Private equity is a real industry now and it’s being challenged by all the things that industries face as they evolve—margin pressure, regulatory pressure and public relations issues.”
Pam Hendrickson

Hendrickson: You have to make it the old-fashioned way, right? Create value. You buy a chimney company, you have to make more chimneys, better chimneys and sell more chimneys.

Steuerman: All of this specialization has an impact on us. As a middle market lender, we have built industry specializations that put us on par with our private equity client base.

Hendrickson: Makes sense because we need that level of understanding to move quickly on deals.

Steuerman: We have dedicated industry teams so that we can limit the borrower specific learning curve and have a fast, intelligent view of the opportunity. This level of expertise allows us to provide high levels of certainty in auctions where all stakeholders are looking for a point of view. Also, as a lender, we have to have financing solutions that match our clients’ investment thesis—while everyone cares about depth of leverage most also want flexible financing structures. Golub Capital has created a capital base that allows us to approach clients as “ask what they need” and design a custom solution that works best. No longer does one size fits all, today private equity investors want to buy a big company, or do a buy-and-build, or execute de novo strategy, and all of those come with different challenges. We have to keep pace with everything that private equity is doing and try to anticipate what’s going to happen next.

Fugazy: Is there room anymore for that middle market $400 million generalist fund, or that generalist lender anymore?

Steuerman: If M&A volume goes back to prior levels and choice becomes more prevalent, then firms will see value in different places and there will be more room for everyone. But given that significant amounts of private equity capital have been raised and that M&A volume has not kept pace, it seems more difficult for the generalist to flourish. You have to pick certain themes and have lots of conviction today. It’s hard to have conviction if you don’t have knowledge and insights from specialization, especially with shorter time horizons with less perfect information.

Hendrickson: Specialization is also helpful for your origination function. The specialization helps to get in front of these deals before they’re coming to the market, then evaluate them faster and ultimately grow the portfolio company more effectively.

Reiner: The origination function at private equity firms has really grown and become a unique role in itself. It seems 10-plus years ago the origination responsibilities rested with the deal professionals. Now some private equity firms have entire business development teams.

Schorr: We have our own research department which helps us research opportunities and supports us in our outbound calling effort. It’s a terrific resource. You’ve got to get more specialists.

Fugazy: Is that the way the industry is heading—more capabilities at all private equity firms?

Steuerman: I think it depends on a firm’s DNA. Using Golub Capital as an example, we have a culture that is focused on continuing process improvement and investment for today and the future. I think we’re fortunate enough to have both the mindset and scale where we can make investments where needed. We are constantly assessing elements such as: how do we make our client relationships better, our deal sourcing better, how do we make our deal selectivity better and how do we improve our portfolio

management elements? To continuously improve you need to make investments in the best people and invest in technology and infrastructure. All of these investments are more easily accomplished with scale.
I believe the best way to assess your effectiveness is as follows: how would you judge your firm if it were a portfolio company? What shocks me is that many firms seem to accept less-perfect elements for themselves than they would for their portfolio companies. The private investing industry is a maturing industry and with maturation comes the need for improvement, investment and continued relevancy.

"The uncertainty is going to change the financing markets a little bit and it's going to require more skill to navigate the boat."

Chip Schorr

Hendrickson: An additional point about why scale is important is because it gives firms the ability to retain talent because they have growth avenues for their young talent. If you're not scaling, young talent is going to leave because there's no upward mobility for them.

Fugazy: How many private equity firms can really survive in today's market?

Hendrickson: What I'm seeing and hearing is that the LPs are trying to write bigger checks to fewer managers because it's just gotten to be too much. I'm going to my scotch analogy — if you think about Scotch Whiskey, it's been around since 1800, it survived prohibition, two world wars, and they did it because they stayed consistent with their brand and they met the needs of their consumers. So when we think about our consumers, we're listening to our investors: They want yield, but less risk, and more liquidity. Scotch has made more blends, but it stuck to scotch. We have to stay consistent, whatever we do at Riverside it still has to be at the small end of the middle market. That's what we're built for.

Steuerman: We need capital to support our private equity client demand and we believe we have the right balance between capital raising and capital deployment. The long-term capital and more direct control over asset purchases and asset divestitures allow private equity firms to have very long lives. While lenders have similar elements, there is a continuous need to have the appropriate scale and solutions to meet private equity client needs. While there are numerous firms considered middle market lenders, there're only a handful of firms that have the scale and foundation to be a full-service lender. For example, having appropriate revolver capabilities and back-office infrastructure takes skill and scale. There are many direct lending platforms that focus on participating in syndications arranged by others as opposed to self-origination – which is a different model than Golub Capital. We are a full-service private equity centric firm that has evolved to our current scale over 20 years. The barriers to entry for a self-origination, full-service agency model are more challenging than ever — which is why there are only a handful of lenders with significant market share.

Schorr: Riverside has built a model around the lower end of the middle market, which is one way to go and then at the other end of the spectrum you have firms building financial supermarkets. These are the asset managers who are going to be all things to all people. Neither model is bad, just different. And lastly, you have the stragglers who haven't actually considered what they are doing. They're just doing it by happenstance. They're not hyper-specialized, they don't have diversification with specialization, nor are they broad based asset managers. They will not last. It will be interesting to see long-term which model is the most successful because it's two diametrically opposed ways to go after the investing market.

Hendrickson: I do think it's important to understand that the small and large markets are different animals. If you're not built to play in the lower part of the market or you're not built to play above it, tyring to do so can be extremely challenging. We could never play in the big part of the market; we don't know what we're doing—so it will be very interesting to see whether people can successfully do that.

Fugazy: Are you finding you have competition coming down from the larger markets?

Schorr: Sometimes yes, you will have been talking to a company for a while and then they'll tell us that they had a visit from somebody and we're scratching our heads wondering why that firm has interest. It's a $240 million sales company doing $40 million of EBITDA and the smallest check the new competitor will normally write is $600 million. It's happened before. In 2001 and 2002, you saw the same thing. There's always been slow periods where bigger firms come and try different strategies. I don't think it's new.

We're unique in that so much of what we do is going out and talking to people about how we can use our capital to help them buy their competitors. We're not really talking to people about selling us their business. Our lead is "we love your industry, here are 15 players that we've talked to in your industry, here's why we think you're unique. Use our capital and let's work together to consolidate your nearest and dearest competitor." That's a different dialogue and that's allowed us to be differentiated.

Steuerman: Historically, most private equity firms transacting at various sizes or stages did so via one core fund. Now it is becoming common for firms to create segmented funds. PE firms have the same corporate umbrella, but they are deploying multiple strategies. I don't think this is a fad. I think they've made commitments to a multi-fund strategy. Private equity professionals now describe themselves as asset managers. I think they're looking at asset management like you would a mutual fund, you have a small cap, a mid cap, and you have a large cap. I think some of these firms are taking that same strategy just on a private equity platform versus a mutual fund platform.

"It seems 10 plus years ago the origination responsibilities rested with the deal professionals. Now some private equity firms have entire business development teams."

Heather Reiner

For us, when it comes to competition we try to assess our chance for success — on credit, on structure, and on the basis of competition — we will frequently self-select out where we have no identifiable advantage. We have valuable resources and have to be judicious where we will spend our time. We know what we're good at and we know what we're not good at. For example, on deal sourcing, we are really good at relationship lending. We've made a two-decade investment in having that skill set and expertise. With regard to credit, we have specific criteria and borrower profiles we find more attractive versus others. Every model works differently and there are examples of success in all strategies.

Reiner: I speak with lenders weekly and one of the biggest issues they talk to me about is the difficulty in sourcing quality deals and then the competitiveness to win. There has been a lot of capital raised and these funds are looking to invest it and are having difficulty. There's a firm I met with recently, they've done two deals in all of 2016. That is not a sustainable model.

Fugazy: What are some of the challenges that firms face as they look to grow? Is growth really a key to success today?

Schorr: I would say consistency in strategy and consistency in team are critical elements of success. So if you outgrow what you're strategically good at, or where you're differentiated, or where you have a competitive advantage, you're going to have a challenge. And so growth-for-growth's sake alone rarely ends well. It's got to be consistent and take advantage of the team's abilities and the firm's DNA.

Steuerman: I consider Golub in the client service business. We provide loans when a private equity client or portfolio company needs our assistance. In some ways we're beholden to someone else creating an opportunity, but then have to react as a preferred provider to solve their need. As our private equity client base grows, we have to grow with it or we become less relevant. For us, one challenge is managing our human capital. For the past four or five years we have significantly grown our assets under management. At that level of growth you have to add solid people and successfully managing and investing in our team drives our success.

How we impart our culture during the new employee on-boarding process is critical. I've been at Golub a long time and I've hired a lot of the people. It's my job to get to know as much about my team members as possible. It's my job to talk with them. I explain how we go to market, our credit tolerances and what we do. We have check-in points. We have gates that need to be crossed. No commitment goes out until we can confirm we did everything we were supposed to do. Those are things you have to think about as you keep scaling. You have to keep your culture while you scale. When I started, we had 10 people. Now we have over 400 people. So how do you get the tenured team members and that last person hired understanding they are on exactly the same mission? That's critical. I have to be the champion of that. That's my mission, my job.

Hendrickson: It's consistency and values, but you can't erode the value system within your company for the sake of growth.

Reiner: A very high priority of William Blair is to keep our core values and culture as we grow. We have invested a lot of effort into how we onboard new employees and keep the strength of the culture that the firm was built on.

Fugazy: What's on the horizon for your firm expansion or the market?

Hendrickson: We might get some regulatory relief, which might be nice. I'm trying to look at the glass half full situation.

Schorr: I think you're going to get volatility. You're going to have inflation. You're seeing wage inflation and inflation over the policy index rate. You've seen interest rates start to back up just on the talking of infrastructure spend and you've got trade uncertainty.

Hendrickson: The geopolitical issues are uncertain and scary.

Schorr: You've got more uncertainty, so you have more volatility. I've started handing out case studies to some of the younger guys on how to manage an inflationary environment and what it does to working capital, because surprisingly, none of them have ever lived in an inflationary environment.

Hendrickson: Right, exactly.

Schorr: They whine about Libor plus 600, and I'm like really? I remember low teens interest rates with a point and a half PIK and warrants—I'm just fine because I have seen it before. The uncertainty is going to change the financing markets a little bit and it's going to require more skill to navigate the boat.

Steuerman: I remember when Libor was 500.

Hendrickson: Welcome to the real world.

Steuerman: So are we going to do fine? Yes. Are we deploying capital in new loans at a reasonable pace? Yes, but we're being cautious. But we are big believers in the middle market and believe the middle market drives growth in the U.S. Besides generational M&A, we believe that there is a backlog of long-dated portfolio companies in private equity portfolios. At some point they have to be released. We watch those companies and we have ways of anticipating when they come out. ■

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