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Q1 2018: PErspectives on U.S. Middle Market Private Equity

Report

March 29, 2018

The market for sub-$1B funds is different: What investors need to know

Private equity for sub-$1B buyout funds is in many ways different than at the higher end for several reasons. Multiples tend to be lower, reflecting the additional work needed for growth as well outsized opportunity for multiple expansion. As targets are often founder or family owned with leaner management teams and less mature systems, there is a premium on effectively navigating idiosyncratic and emotional reactions of sellers, management teams and their counsel. Funds at this end of the market expect advisors to keep costs in line with the enterprise value of the target, while providing continuity of staffing by professionals who are involved in a high volume of buyouts and who are able to effectively close deals and manage risk. Section 1202 of the Internal Revenue Code, which

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allows private equity funds to avoid the 23.8% federal capital gains tax on dispositions of qualified portfolio companies, is available more often to funds at this end of the market.

With the amount of dry powder at record levels and control-oriented funds in this sector showing discipline (with year-over-year transaction volume and purchase price multiples declining), the sophistication of deal sourcing and industry relationship building at this end of the market increasingly mimics that of the larger end. And while interest rates have been rising and dry powder and valuations are at or near record levels, there is reason to be relatively optimistic. The proportion of dry powder and AUM for these funds relative to other private markets strategies has declined by almost 25% during the past decade, yet returns for these funds over economic cycles have outpaced or kept pace with both other private market strategies and the S&P 500.

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