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Middle Market Private Equity

Nationally Top-Ranked Team Sees Opportunity Ahead for Distinctive Subset of U.S. Sub-$1B Buyout Funds

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Transaction metrics for 2017 and the first quarter of 2018 for the overall U.S. middle market for buyouts and the subsector of sub-$1B funds require context, and were mixed and divergent. For context, U.S. middle market buyout deal flow, purchase price multiples, exit activity, and fundraising continue to remain at historically elevated levels, as they do for the subset of sub-$1B funds.

While deal flow for the overall market rose in 2017 compared to the prior year, the subset of sub-$1B funds experienced a decrease. Additionally, purchase price multiples increased during 2017 for the overall market; however, the subset of sub-$1B funds saw a marginal downturn in purchase price multiples, suggesting that these sub-$1B funds were showing more discipline than at the larger end. Exit activity decreased below the long-term trend for the

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overall market, while the subset of sub-$1B funds experienced an increase. These metrics suggest relative discipline during 2017 for these sub-$1B funds as well as relatively favorable exit metrics.

These metrics for the first quarter of 2018 for the subset of these sub-$1B funds continued to diverge somewhat from the overall market. The tide turned during the first quarter of 2018, as deal flow for these sub-$1B funds accelerated and set an all-time record for any first quarter, while the overall market witnessed a decrease. And while exit value and volume for these sub-$1B buyout funds for the first quarter of 2018 were up and stable, respectively, compared to the prior year, the overall market saw a marked decrease in exit value and volume. These metrics indicate that these sub-$1B funds were relatively more active in deploying capital during the first quarter of 2018 than their larger counterparts, while maintaining relatively favorable exit metrics.

As for fundraising for these sub-$1B funds, after a record setting 2017, they got off to a slower start on an absolute and relative basis.

While these sub-$1B funds continue to adopt many best practices of larger funds, this subsector's metrics and recipes for success remain distinct. As discussed further below, as these sub-$1B funds become more sophisticated and increasingly adopt a number of strategies and best practices of larger funds, their deals remain different from those of their larger counterparts and require a nimble and deft touch to accommodate the distinct characteristics of their counterparties.

Litigation Strategies in Federal Court

How Sub-$1B U.S. Buyout Funds Differ Their From Larger Counterparts

"Funds at this end of the market require special attention," says E. Paul Quinn, a *Chambers*-rated Akerman partner who represents private equity funds and their portfolio companies. He says these clients require a "higher touch." "While effectiveness and working on a high volume of transactions are just two components of table stakes for private equity lawyers, clients in this subsector of the market require exceptional responsiveness, efficiency, and continuity of staffing," says Quinn.

Also, these funds tend to have fewer internal resources than larger funds, which means outside counsel and other advisers often are called on to play bigger roles. Funds of this size tend to lean relatively more on lawyers for their business acumen and a mastery of the legal details in getting deals closed in a manner that optimizes the client's particular organizational and transactional goals while mitigating risk.

> ” Funds are becoming increasingly sensitive to the unique concerns of family businesses

"Business development for middle market firms is different, too, and can often benefit from help that outside advisers or lawyers can lend in sourcing," says Akerman partner, Palash I. Pandya, co-deputy chair of the Corporate Practice Group. "We work with our clients by holding events and making introductions for them to source deals and meet others in the industry," says Pandya. He says the feedback for the firm's "Deal Bridge" events, which include brief, rotating one-on-one meetings for investment banking and private equity professionals and involve other relationship building activities, has been overwhelmingly positive.

Sub-$1B Funds Are Sensitive to Family Businesses

Family businesses remain an important target, and funds and their advisers in this subsector increasingly prioritize being sensitive to the special concerns of founders and other family owners. A genteel bedside manner often is required in deals where a founder is relinquishing a business built over a lifetime. Aggressive buyer posturing that might be taken in stride by professional fund managers can seem disrespectful to these sellers. Patience and cultivation of a collaborative approach is enormously helpful in getting these deals done.

> ” Purchase price multiples in this end of the market continue to be lower than those of larger deals

Family businesses often have more loose ends, too, and may not be ready for sale. Due diligence in these deals can be especially important, because these companies may have a less formal framework for financial data or may not fully understand the process. Again, advisers and lawyers with experience working with these companies can facilitate a smoother process designed to maintain constructive relationships with sellers and management.

Adopting Larger Counterpart Best Practices

Not everything is different, however. Just as many larger funds specialize in industries or develop sophisticated analytics, firms in this subsector also are adopting similar strategies. For example, to improve returns, fund managers increasingly are focused on better understanding the ecosystems within industry subsectors of interest, including getting to know target management teams before their companies come to market. Funds in this subsector also are increasingly demonstrating to management teams of putative targets that they are exceptional partners who facilitate growth and development of portfolio company management teams.

Representation and Warranty Insurance Now Common

Another aspect of the evolution of this subsector of middle market deals is that representation and warranty insurance has become prevalent. Bidders know that in order to be competitive, most deals need policies that shift post-closing risks from the seller to the insurer. Premiums and retention percentages have gone down while the scope of coverage has increased. In light of these policies, principals and their counsel are able to streamline the negotiation process and focus relatively more attention on relatively fewer issues.

Opportunities Will Continue for Sub-$1B Funds

There remain opportunities for favorable returns in this subsector of the private markets compared with global markets in general. While purchase price multiples and valuations in this end of the private markets are at historically elevated levels, they continue to be lower than those of larger deals and in the public markets. This relative difference suggests an opportunity for multiple expansion for companies in this subsector that successfully grow earnings organically and through acquisitions. Likewise, the historic risk-adjusted outperformance of U.S. middle market buyout funds, vis-à-vis global markets in general, suggests an opportunity for relative outperformance. And while purchase price multiples remain at historically elevated levels, the aggregate value of companies in this subsector has not grown relative to the market capitalization of the Russell 2000. The recent marginal decline in purchase price multiples in this subsector (suggesting relative discipline and prudence by investors) coupled with these other factors, bode well for future returns on a relative basis.

For those who are adept at relationship-based transaction sourcing and who have the patience for the hands-on requirements of this subsector, the opportunities are likely to continue to unfold in the year ahead assuming that the economic expansion continues, credit markets remain benign, and interest rates do not rise in a disorderly manner. The reduction of the federal marginal corporate income tax rate and revision of Section 1202 of the Internal Revenue Code, which allows private equity funds to avoid the 23.8 percent federal capital gains tax on dispositions of qualified portfolio companies, should be a tailwind.

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