Privcap/Report

Q2 2017 Dealmaker Roundup

Includes a bonus interview with

Tom Lister

Co-Managing Partner, Permira

Featured Topics

Dead-Cat Bounce in Q2?

Need for More Deals Like Staples

Healthcare's Strong Showing

Interest Deductability

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About This Report

This publication is a companion to Privcap's Dealmaker Roundup, a quarterly video program on the latest trends in private equity dealmaking.

About the Experts

Michael Fanelli is a partner in the Transaction Advisory Services practice at RSM US LLP, focusing on retail and consumer products and business and professional services. He performs transaction advisory services on both buy-side and sell-side transactions, assisting both financial and strategic buyers. Prior to his transaction advisory experience, Fanelli worked as a controller of a middle-market company and as an auditor at a Big Four accounting firm.
Learn more about **RSM here.**

Ryan Flanders is the Head of Private Debt Products at Preqin and leads all efforts within the private credit asset class. This includes, direct lending, mezzanine, distressed debt, venture debt and special situations. Preqin is the alternative assets industry's leading source of data and intelligence. He has been with Preqin for over 5 years and is a Chartered Alternative Investment Analyst (CAIA).
Learn more about **Preqin here.**

David Snow is CEO and co-founder of Privcap Media, the leading channel for thought leadership in private capital investment.
www.privcap.com

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Dead-Cat Bounce?

Privcap: Has there been a dead cat bounce in the private equity deal market? Typically in the first quarter of a year, there is a little bit of a dip in deal activity for a number of reasons. But, then there's typically a come-back in the second quarter. But in the second quarter of 2017 there wasn't as much of a bounce back.

Michael Fanelli, RSM: Within our practice we saw essentially the same trend from a numbers perspective. We're doing the due diligence before the deals actually close, so I have insight into this. March and April were a lot slower than we were expecting, which would fall into those Q2 deal closes. So, while we did see the bounce after Q1, to your point, it was much less.

When we talked to our private equity firm clients, the sellers they were talking to just were not ready to sell. They were not ready to sign a Letter of Intent or an Indication of Interest or otherwise. The bankers we talked to had a huge pipeline, but they weren't ready to put it out in the market yet.

Moving into work that were doing that was likely close in Q3, we've seen a significant uptick. The pipeline for July has been really strong - potentially our three highest volume ever. So I'm going to assume that Q3 private equity deal counts are going to be up compared to the prior year.

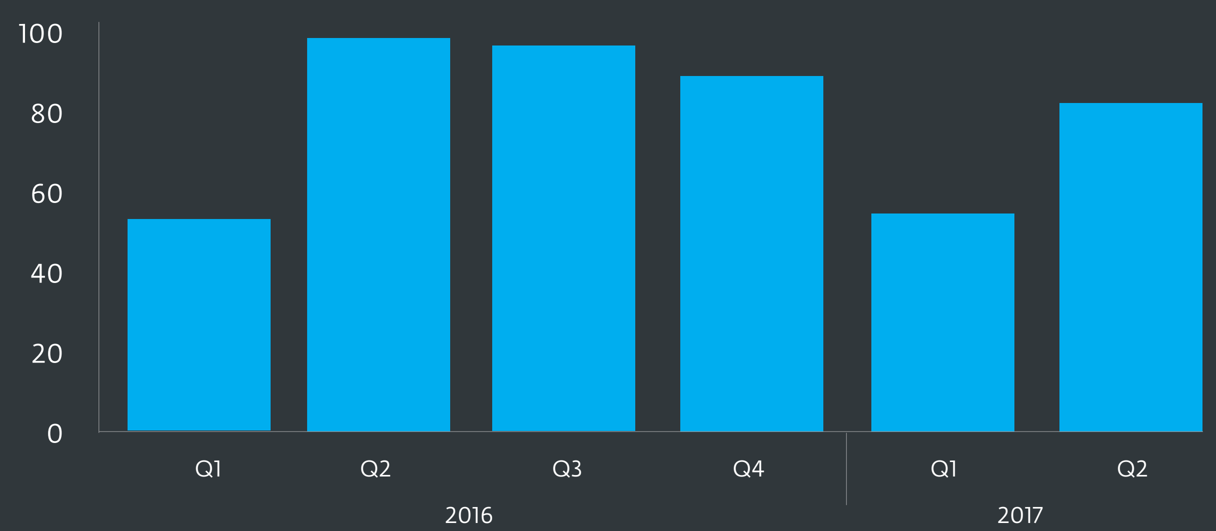
Ryan Flanders, Preqin: Given all the dry powder, do you expect to see the multiples trade even higher? Are these portfolio company's going to be selling at an even higher premium?

Fanelli: From the private equity firms that we speak to, we don't think it's going to go exponentially higher, but we also don't see any reason for multiples to go down. Even if the interest rates increase a little bit, we just don't see that impacting things too much. Just because of supply and demand.

That said, the traditional bank lenders, as well as non-bank lenders, don't seem to be stretching it too much either right now. The debt multiples are at a reasonable level. We're not seeing covenant-light, or zero covenants. We're probably at a happy medium in terms of having the right amount of debt available at reasonable debt multiples, and with some level of covenants, just to keep everyone honest.

Flanders: I would agree. While there has been a slight loosening of covenants here and there, it's not been prevalent throughout the market. On the equity side, you're still continuing to see pretty high equity contributions in these transactions. So, people are still sticking to their guns in terms of diligence and being very thoughtful about where they're putting their money in the market.

Deal volume came back in Q2 2017, but not as strongly as a year earlier ($B)



Source: Preqin

Need More Staples

Privcap: It's becoming a bit of a broken record, but in the second quarter we had yet again a new record level of dry powder. With a dead cat bounce of a Q2 deal volume recovery, all this dry powder is not getting put to work at a rate that would justify the incredible amounts of fundraising happening. The largest private equity firms are going to need to start doing more large deals, and public-to-private transactions tend to play that role. In the second quarter we did see the announced Staples transaction, which Sycamore Partners wants to take private for $6.9 billion. What is your impression of that deal?

Fanelli: With the larger private equity firms having that much dry powder, they're going have to do more deals like Staples. But a lot of these deals are not for the faint of heart - they're typically going from public to private for a reason. That reason is typically because shareholder value has been on the decline and management needs to transform their business outside of the public eye. Staples, I think, is a perfect example of that. They are in a mode where they've had years of consistent declining sales. They're in a scenario of store closures, just like everything else in retail. But, they still have a business there.

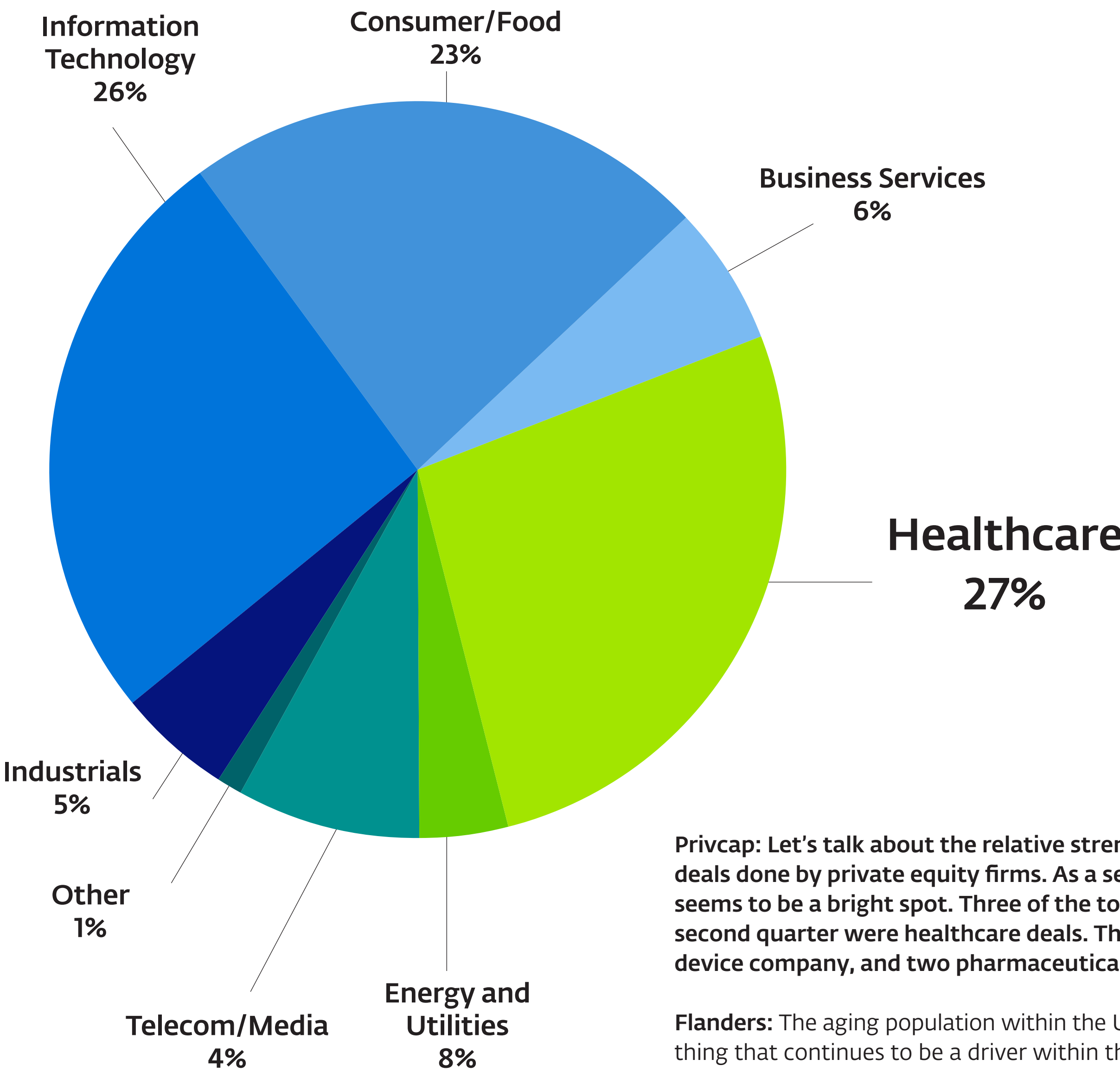
The challenge is—who is Sycamore going to sell it to? It's probably not going to go public again. Is it another private equity firm that's bigger than them that would take it on? I'm not certain about that. Is it a Wal-Mart play? Target? Amazon?

Flanders: I think the specialist approach from a firm like Sycamore is certainly a play that makes a lot of sense. Being able to make those operational changes, and make those store closures outside of the public eye will be a big benefit. Without that operational expertise, there's a significant execution risk. It's not a typical leverage buyout where you're buying the company, improve the margins a little bit then sell it three to five years later. There's going to be significant business transformation that needs to happen at Staples.

Healthcare Deals

Health Piece of the Deal Pie

Sector by sector percentage of overall PE deal market, Q2 2017



Privcap: Let's talk about the relative strength of healthcare deals done by private equity firms. As a sector, healthcare seems to be a bright spot. Three of the top ten deals of the second quarter were healthcare deals. There was a medical device company, and two pharmaceutical companies.

Flanders: The aging population within the US is certainly something that continues to be a driver within the heathcare space. When you're talking about the potential growth in healthcare it kind of outweighs the indecision within Washington.

Fanelli: We're seeing a lot of roll-ups of physician practices, such as dermatology, etc. We're not seeing as much in the hospital space, and we're not seeing much where there's reimbursement risk. But we are seeing medical devices, pharma, and we are seeing the specialty practices where you can have a niche regional practice, and then continue to add on throughout the country to get some synergies.

Interest Deductibility

Privcap: How big of a deal is the proposal currently circulating in Washington to end a private equity firm's ability to deduct interest costs for tax purposes. If this change happens, how badly will it impact the economics of buyout deals?

Flanders: The market is trying to get some sense of finality on what's going to happen. Finality and predictability are good for deal making within the private equity space and on the debt side of the transaction as well.

Fanelli: We had a full discussion on regulatory matters, tax matters, et cetera, with one of our larger private equity clients. When we talk about the potential removal of the interest deduction, I don't want to say they were freaking out about it, but they were not keen on it whatsoever. It would significantly change the returns within the fund, obviously. But they're also talking about tax reform in Washington, including the corporate tax rate. And so it is unlikely that interest deductibility is the only change that will be made, and if you look at the totality of it, that one item won't make a big impact. ■

POWER HOUSES

IN PRIVATE EQUITY:

Tom Lister

Insights from the world's leading investors and dealmakers

Mentored by a Legend

Tom Lister
Co-Managing Partner,
Permira

Permira Co-Managing Partner Tom Lister got his start working at seminal private equity firm Forstmann Little, led by Ted Forstmann. Lister recalls two points of investing philosophy that served Forstmann well:

"Ted had a philosophy of monetizing or selling things when there was still an amount of money to be made by the next owner. That wasn't to say we wanted to sell too early, but we had this point of view that it was good for people to do well with what we had owned after we sold it. And that really is a philosophy that we've carried on since I've been here at Permira—making sure that you monetize the investments once you've made a good, and in some cases, an excellent return, but making sure that those businesses have room to grow, room to continue.

"The other one was not being obsessed by or swayed by quarterly performance or challenges in the beginning. If in the end your theory about why you made the investment was correct, you'd ultimately be paid well for it. So in some cases if you go back and look at the first year of an investment, it was tough. I remember saying to Ted, you know, we missed our forecast on this, or we're behind plan. And his answer always was, "It doesn't necessarily come out of a computer. You don't have to focus only on quarterly results. If we're right about the theory, four or five years from now we'll make an outsized return on the investment." I think that's always an important thing to remember about both investing and, in particular, private equity. ■