Privcap/ Report

Q1 2018

Dealmaker Roundup

▶ 2018 Preview

Includes a bonus interview with

Howard Newman

Chairman & CEO, Pine Brook

Featured Topics

- **The Middle Market Is On Fire, But Will It Last?**
- **Why Are Exits Declining?**
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Click to watch the full program

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

Felice Egidio is the head of Venture Capital for Preqin, where he oversees all venture capital product development, research, and strategy. Prior to this role, Felice launched Preqin's San Francisco office, managing the growth and expansion of Preqin's West Coast operations. Preqin is the alternative assets industry's leading source of data and intelligence. Their products and services are utilized by more than 24,000 professionals in over 94 countries for a range of activities including investor relations, fundraising and marketing, and market research.
Learn more about Preqin here.

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.

Jeff Burkett is a director at Harris Williams & Co.'s Transportation & Logistics Group. He has 13 years of investment banking and financial advisory experience executing mergers, acquisitions, various capital market financings, and corporate strategy and shareholder defense assignments. Prior to joining Harris Williams & Co., Burkett was a vice president in the Transportation and Logistics Group at Morgan Stanley, where he advised both public and private companies in a variety of M&A and strategic advisory assignments. He also worked in Morgan Stanley's Natural Resource Group in Hong Kong.
Learn more about Harris Williams & Co. here.

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

The Middle Market Is On Fire, But Will It Last?

A panel of private equity deal experts recently discussed the trends behind recent deal statistics and found steady growth in the global middle market but a dearth of mega-deals, despite a huge cache of dry powder.

Privcap: Just one month into 2018, the U.S. middle market private equity deal market is seeing major growth. What is driving this deal activity and what effect is it having on your 2018 pipeline?

Michael Fanelli, RSM US LLP: The middle market just continues to be on fire, both within private equity and within the corporate strategic buyer space: 2017 was our highest-volume calendar year to date, and January, which is typically slow, has started off strong. We're at full capacity, and it looks like 2018 is going to continue that way. The interesting thing, too, is it seems to be across all industry sectors.

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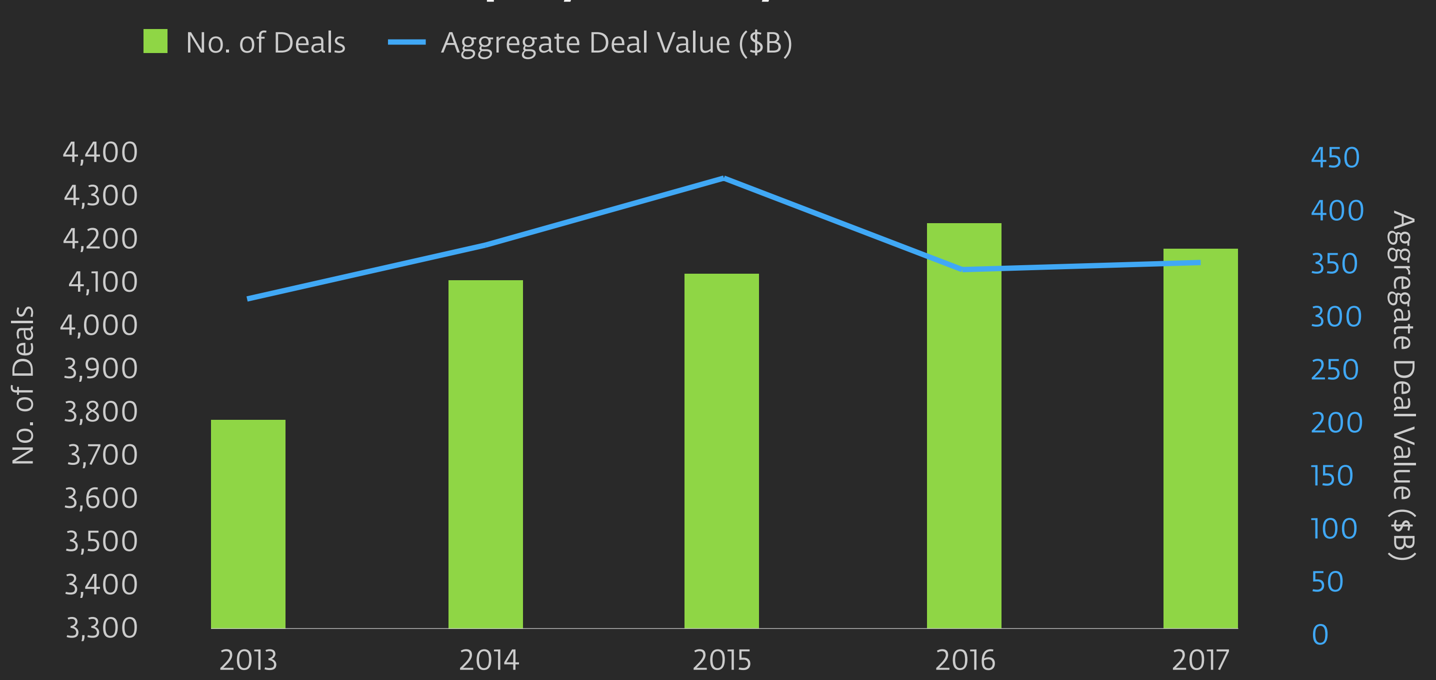
Global Private Equity Deals, by Year



Source: Preqin

“There were more transactions in 2017 than in any other year to date. Transaction volume was up 20 percent, year over year, in terms of aggregate deal value.”

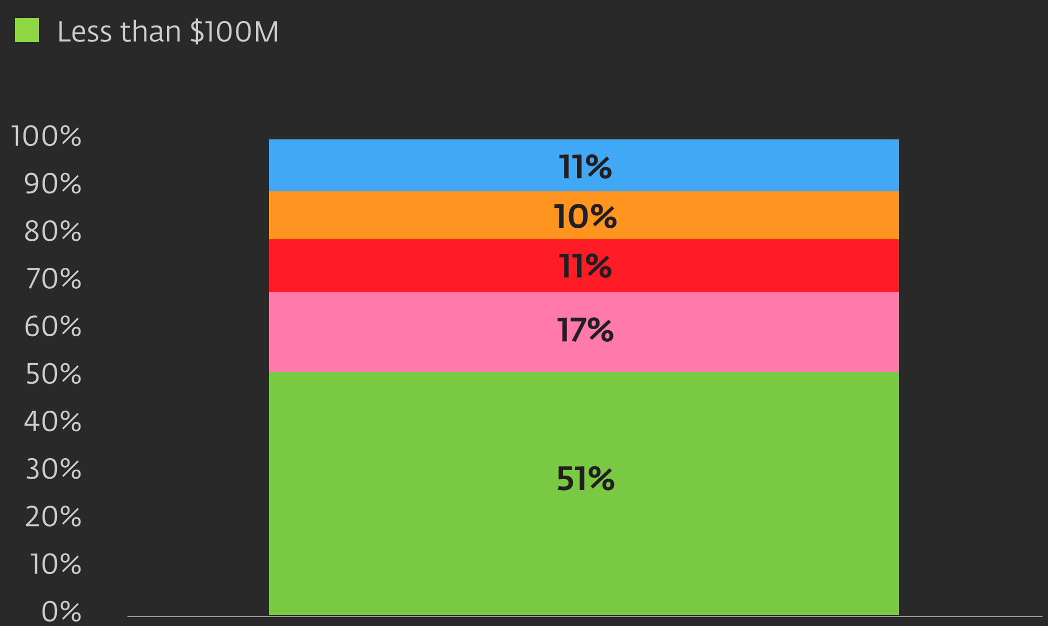
–Jeff Burkett, Harris Williams & Co.

Jeff, as an advisor to middle-market deals, what did 2017 look like for Harris Williams, and what does 2018 look like now?

Jeff Burkett, Harris Williams & Co.: I echo a lot of what Michael said: 2017 was a record year for Harris Williams. There were more transactions in 2017 than in any other year to date. Transaction volume was up 20 percent, year over year, in terms of aggregate deal value. We're seeing broad-based activity—buyers that are well-heeled with equity and debt capital, bidding aggressively on high-quality assets across the board in all of our sectors.

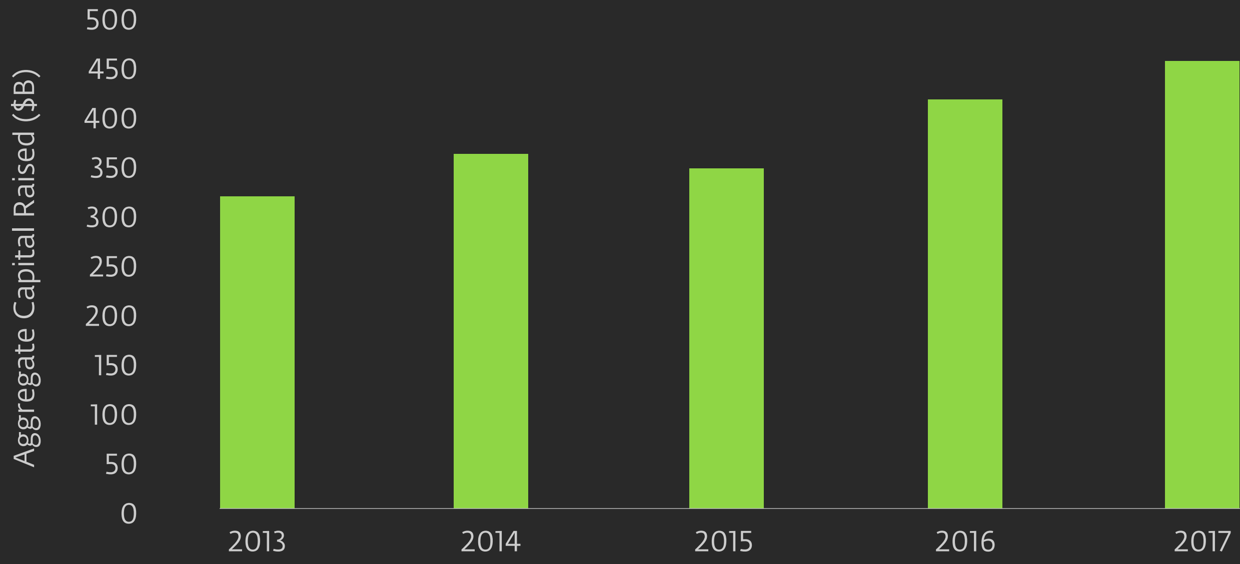
Felice, Preqin follows the numbers in the global alternative investment asset classes. Can you explain the dichotomy in the private equity market between the middle and lower middle markets, on the one hand, and mega-deals? It's notable that deals under $100 million in value comprise the bulk, or even the majority, of deals done in 2017. Yet the overwhelming amount of capital raised for private equity is raised by large mega-funds. It appears that this capital is not getting put to work at the same pace they're raising it. Do you see a reason why this now $1 trillion dollar heap of dry powder remains untouched?

Number of PE Deals Done in 2017, by Value Band



Source: Preqin

Global Private Equity Fundraising Total, by Year



Source: Preqin

Felice Egidio, Preqin: The mega-funds are driving dry powder figures up significantly. That's why we're able to hit that over $1 trillion dry powder figure. But in terms of the overall deal marketplace, we've spoken with a lot of fund managers and institutional investors. Valuations remain a high concern, so entering the marketplace at this time, with the current asset prices is a little chaotic. I believe fund managers are sitting back on their capital and waiting to find the right price point.

So the good new is that we have tons of money, but the bad news is everything's expensive. What are the challenges in putting that much capital to work?

Burkett: We're seeing a lot of those larger funds come down into the middle market—and what is a good-size asset for us, or even a larger asset, is one of the smaller assets for these larger mega-funds. They have a much bigger thesis in mind, for that company, than maybe a middle-market private equity fund would, whether it's to take it global or to take it into a new market. I think they're flush with capital, and they have the mandate to put it to work.

Just what the middle market needs, more competition. Michael, have you seen any of that—larger firms dipping into smaller deals because they just have to put that capital to work?

Fanelli: Yeah, big time. They have to put the capital to work in their, typically, 10-year fund investment horizon, also with the roll-up strategies that people are continuing to entail, which means they're going to have to, inevitably, do add-ons in the lower middle market as well. It will be interesting to see if we see more take-privates. We saw a lot in 2017, but are we going to see even more take-privates or, potentially, corporate carve-outs, a billion-dollar division of a multi-billion-dollar company?

Why Are Exits Declining?

Let's move on to private equity exits. An exit is an important kind of deal in the private equity landscape. There's an interesting and possibly worrisome trend among private equity exits. Do you agree?

Fanelli: A private equity firm won't sell a portfolio company if it hasn't executed on its strategy laid out in a plan from the time acquisition. If they've got 2x, 3x, 4x their money, they will put it into the marketplace tomorrow. From the Harris Williams side of things, if they have something in their portfolio that's older than—call it, five years, you'd have to be concerned that they haven't executed on the strategy, and potentially the business isn't growing and/or maybe on the decline, and/or there isn't an actual buyer for it.

Jeff, do you agree? What do you think is behind the declining exits in private equity? Given the rising of valuations generally, you would think that private equity firms would have a motivation to sell almost anything that's not bolted down to the floor. Why is that not happening?

Burkett: You bring up a really interesting point, that time is becoming less of a key metric for "Is the company ripe for sale?" If it's been six years, I think you are starting to see more questions from buyers. After six years, they're really looking for results, and if that's operational improvements or a new product launch, they want to see actual return for that time.

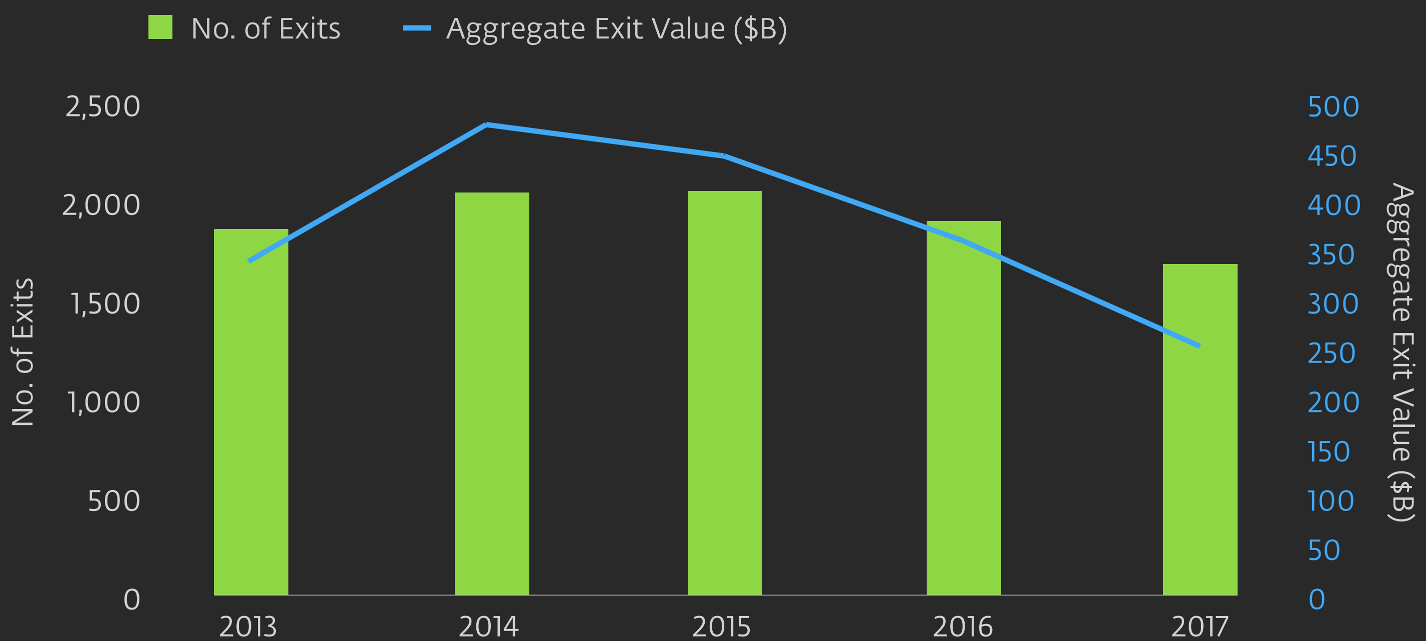
With respect to exits, can you comment on what trends you are currently seeing in the IPO marketplace?

Egidio: An issue I'm seeing within the IPO marketplace has to do with the performance of tech IPOs. We look at Snap, we look at Blue Apron. These companies carried lofty valuation expectations. When they hit the public markets, they just, I don't want to say tanked, but they struggled. That's amongst one of the reasons we're seeing a lack of tech IPOs within the marketplace.

AppDynamics filed to go public the day before they were about to list and were purchased by Cisco for, I think it was 3.7 billion. Are there attractive alternatives to going public—namely, being acquired, or getting a huge round of financing or huge investment? Can you speak to the rise of these mega tech VC entities that are probably depressing the volume of tech IPOs in the market?

Egidio: Sure. We saw it this year with SoftBank Capital raising their hundred-billion-dollar vision fund. There are plans by Sequoia Capital to enter the marketplace with a $6 billion dollar growth fund. These mega VC funds who are entering the marketplace to compete with the likes of SoftBank are throwing money at literally any company that isn't nailed down, to purchase a significant ownership within that. As an entrepreneur, you get to sit back and say, "Well, I don't need to go public."

Number and Value of PE Exits, by Year



Source: Preqin

Industrials Are Hot

Why don't we move on to a discussion about industrials, a sector of the economy that has seen quite a lot of deal activity? And in fact, it's the leading sector in which private equity deals are done. Jeff, can you talk about what is behind the surge in dealmaking in industrials as well as some of the trends you are seeing in this sector?

Burkett: Lest we not forget that in 2015, and even into '16, there was a bit of an industrial recession. The overall economy was humming along and masked that, but I think '17 was a really powerful year for industrials, within a number of subverticals—because the recession unwound itself, which actually plays into my specific sector of focus, transportation and logistics. When goods move through the supply chain and through the economy, we certainly saw that industrial pickup, not only from deal activity, but through the companies we represent, within transportation and logi tics. In particular, the convergence of technology plays into all of these sub-sectors and is a very real phenomenon.

Transportation deal activity tends to follow the rise and fall of just the general circulation of goods and people, I take it?

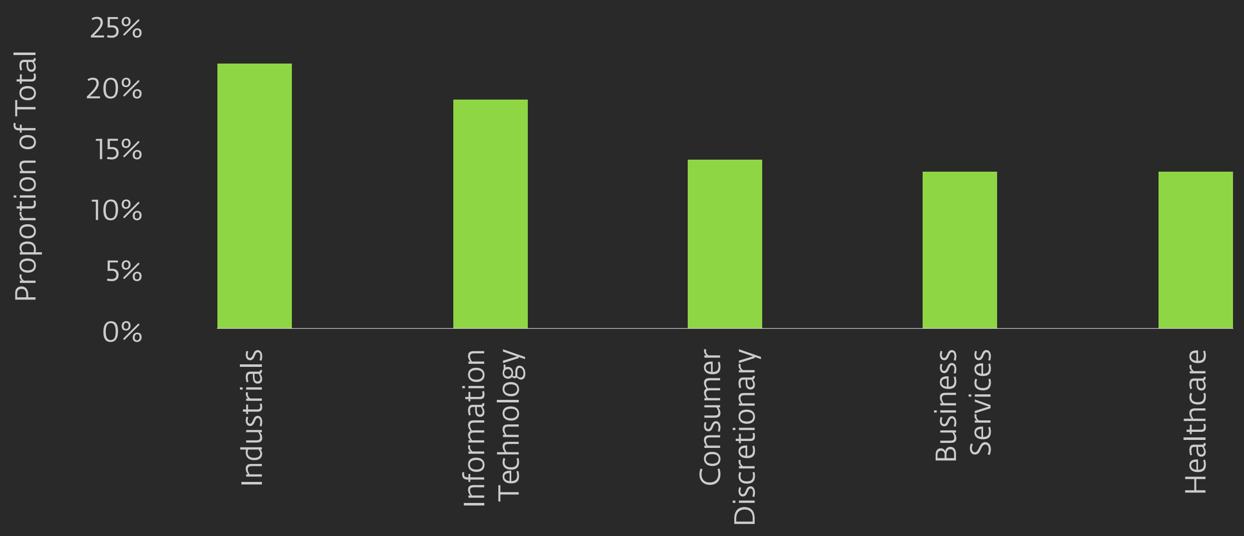
Burkett: Yeah. If you think about rail and marine, those tend to be larger bulk commodities that are making their way in and around the U.S. and globally.

Fanelli: I think there's a lot of private equity firms who are more generalist in nature but have operational expertise from other places, and it's just a place where they are migrating to, because they can really impact those types of businesses with true operational improvements. You just have this accumulation of all the different facets which are making these private equity firms highly active in industrials.

We talked about the fact that U.S. industrials have been in a slump for a long time. That suggests an underinvestment in those types of businesses. And so perhaps now is the time for private equity firms with good operational insights to come into these companies and maybe do things that have not been done previously.

Fanelli: It's a challenge, too, because a lot of them in the mini market are family-owned businesses, and if they're manufacturing, they've been around a long time. If you can get there and you can have a significant amount of management rollover equity, a lot of times I have a laundry list of good stories, where the family made just as much, if not more, money on the second exit from the rollover equity as they did in the first.

Number of PE Deals Done in 2017, by Industry



Source: Preqin

Strategic Buyers vs. PE Buyers

I'd love to hear from all of you about what you're going to be watching most carefully in the deal market in 2018?

Egidio: Corporates have a bunch of cash. They'll be bringing offshore cash back in. They can certainly invest it in their own business, but I still think we're going to have a lot of it left to continue to deploy M&A.

In the old days, strategics were able to pay more for assets, just because of the assumption of synergies once the add-on is made. In recent years, private equity firms have actually been paying more, in general, for some assets. Is that still going to be the case? What's driving that from your perspective.

Burkett: The age-old adage is still true in a process where strategics have more synergies to wring out of a transaction than a private equity fund. They most often will carry the day. They're as savvy as those private equity funds, in many cases. They will pay one dollar, in many instances, more than the private equity fund, but they will, and can, carry the day, should they want to.

Fanelli: I think the other reason why it's the strategic versus private equity: Private equity's gone up a little bit. Whereas strategics have gone down, in terms of their pricing models, because of the difficulties with integrations in the past. I think some of the large corporate strategic acquisitions that involve massive integrations, there's probably more realistic expectations about the integration process, because there's huge execution risk.

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>
> –Felice Egidio, Preqin

Egidio: Asia, for example, from a macro prospective, is very interesting. A lot of the money in China stays in China. The government has restrictions on the amount of USD investment that can come in, so fund managers are raising RMB, local-currency-specific funds to reinvest directly into Chinese technology. We're seeing a lot of the deal activity, and to be honest, 2018, I see it exceeding that. From a PE perspective, we saw China rival the U.S. That's only going to continue to grow, especially as we have these mega-funds that are going to be reinvesting. ■

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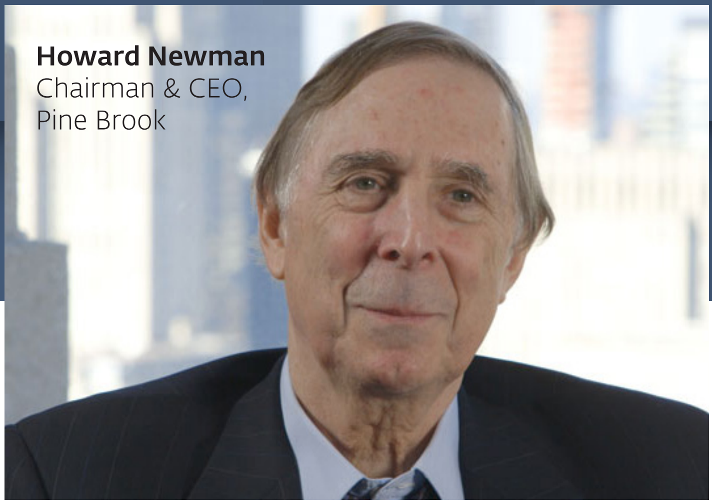

What do you see as the opportunities in the evolving financial services space?

Financial services is as interesting now as it's ever been. The growth in the demand for financial services is likely to exceed the growth in income going forward. The question is whether that demand could be completely eliminated by technology. I don't think so. Technology is just a way to do things better, faster, cheaper.

What do you see as some areas of technology that have helped financial services?

Look at one recent example of the great fintech inventions in the last few years, Airbnb. When I was a graduate student in Europe, I used to travel around, and you'd pull into the center of a town and there would be the war widows out there saying, "Room for let, room for let," right? Is that any different than Airbnb? It's just a more efficient way of delivering the same service, right? Great financial service technologies are simply embodiments of existing businesses.

So the outlook for financial services as an investor remains very bright. It's going to require you to continue to be nimble, to take advantage of dislocations, which are caused either by regulation or by technology or by growth. But the opportunity set remains really strong in that area.

Moving on to the growing energy sector, what do you see as the future for global energy?

The world population is going to grow from 6 billion to 9 billion, and that means that the population will consume more energy. The issue is that we won't be able to conserve as much as we consume. I think the mix will move to lower-carbon-generating sources, because we've invested enough capital in those from a social perspective to begin to make them economic. Wind, solar, and alternatives are getting to the point where they no longer need the subsidies we've been giving them.

Renewables are the darling for government subsidies, but what are your thoughts on oil and gas?

Big subsidies are given to wind and solar, and those subsidies will bring those technologies to bear. They're not going to eliminate the need for fossil fuels. They may and should eliminate the need for coal, but the marketplace eliminated the need for coal. It's called natural gas. If you produce electricity with natural gas, you produce half the carbon dioxide per kilowatt as you do with coal.

Now we know where all the natural gas is. We don't need coal. We don't need to legislate or regulate coal out of existence. The market's going to do that for us. Looking forward with fossil fuels, you'll see less coal, more natural gas and oil. Oil is going to be driven by the growth of transportation in the developing world, where electric vehicles will increase in developing countries. But I don't see oil going away, at least not in my investing or post-investing horizon. ■