

BY THOMAS BONNEY

Optimism Rising in the Middle Market

Despite concerns ranging from regulations to crises abroad, the mood is more upbeat as deal multiples and closing times improve



Most of the middle-market private equity funds and investment banks we spoke with seem to be taking the recent global events in stride.

CMF Associates was in San Diego in late March to attend the Association for Corporate Growth's national mergers and acquisition conference for middle-market private equity.

We came away with a strong sense that this sector is rebounding and the mood is shifting toward optimism.

Attendance reached a record high at over 2,000, including over 200 walk-ins. Events, panels and breakout sessions were well-attended and people were clearly in a better frame of mind than they have been in a few years.

To gain more insight on fund activity, CMF surveyed private-equity executives at the conference to find out exactly where averages surrounding deals and acquisitions are now.

We found that, based on recent activity, a plurality of deals are taking six to eight months to close from first meeting to signing.

Out of 22 private-equity professionals surveyed, nine, or 41%, closed within that time period. Seven took four to six months, four took less than three months and two took eight to 10 months.

Also, the most frequent Ebitda multiple was six. Ten of the 22 surveyed, or 46%, gave that answer. One of the other Ebitda responses was in double digits.

And comparative sales in 2011 over 2010 at the existing portfolio as a whole are expected to increase 5-10% organically.

That's not bad in an economy that is growing 2-3%.

These results indicated that long-term "normal" is becoming the new normal as diligence and specific negotiated deal points are resulting in multiples and time frames to close that tend toward historical averages.

However, reflecting on the conversations my colleagues and I had at these events, we agreed that while the tempo was generally upbeat, there are still certain concerns that seemed to weigh on the shoulders of managing directors at private-equity shops and sell-side investment banks, most of which fit into the following themes:

Exiting Portfolios: A main concern for PE funds recently has been their existing

portfolio. Due to the economic conditions of 2009-2010, few portfolio company exits were completed, and, of course, the funds need to exit investments to return capital to limited partners.

Now that the economy has stabilized and rebounded slightly, many funds are preparing for multiple exits within the next 12 months.

Deal activity was validated as investment banks mentioned involvement in private-equity "beauty pageants," a process in which a fund runs a request-for-proposal process to select the investment bank to represent them in the sale of the portfolio company.

Deal Flow: Investment banks and private-equity funds acknowledge that the quantity of new deals entering the top of the funnel has been "choppy" over the past four months. Companies that wanted to sell in the past few years have been holding off until their revenue and Ebitda numbers rebounded and are just now looking for buyers.

So while a greater number of deals out on the market are not Grade-A quality, they could ultimately have some potential.

However, there are relevant indicators — such as increases in sell-side investment bank pitches — that deal quality and volume will stabilize, with mandates expected to increase during the second half of the second quarter.

As noted, portfolio company exits are expected to increase, which will add to the supply of selling companies.

Furthermore, we expect entrepreneurs who have weathered the storm and gotten their businesses back to profitability will be reentering the market to sell their businesses.

Auctions: Auctions are common ways for investment banks to ensure that a seller gets the best price for his or her company. Auctions appear to be getting more competitive, which is inflating multiples at a time when leverage is re-entering the market.

Private-equity funds find themselves in efficient, auction-like situations, making acquisitions and return on investment challenging.

Cash-heavy strategic buyers are a formidable obstacle to private-equity acquisi-

tions as they are also often able to pay a higher multiple based on "synergies."

Regulations: Many funds we spoke with expressed concern about looming regulations and the ultimate impact of implementing the Dodd-Frank Act on middle-market private equity. Currently, private-equity funds do not have to register with the Securities and Exchange Commission.

If the act is fully implemented, all investment advisers, including private-equity firms, will have to follow the costly regulations of the SEC.

Smaller funds in particular are concerned about the hard costs (estimated by some to be between \$500,000 and \$1 million) and the distraction of the managing director's attention in complying with the new regulations.

Crises Abroad: It seems that each week there is a new crisis. Oil around \$110 per barrel. Unrest in the Middle East. Nuclear radiation in Japan. No reaction in Washington on government financial matters — all of these seem to have had limited impact on middle-market investment professionals.

With crises coming from all ends of the earth and affecting all manner of business, there is little we haven't seen lately.

Most of the middle-market private equity funds and investment banks we spoke with seem to be taking the recent global events in stride and are focusing on their particular segment of the world and their deals.

It appears that the financial crisis of 2008-2009 has hardened the middle-market executives to the ever-more-frequent geopolitical anomalies. Concerns are many, but perhaps that is just the aftermath of a rough two years in the middle-market private equity world.

While most professionals in this realm have their reservations and skepticism, the portfolio is growing, the deals are flowing and the economy seems to be on a steady climb, with the occasional pullback.

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