TheDeal Magazine
VOICE OF THE DEAL ECONOMY

Drilling down

By Thomas Bonney, CMF Associates
Published January 15, 2009 at 1:52 PM

The growing political imperative for energy independence and the volatility in energy pricing have provoked significant investment in Western Pennsylvania, home of the increasingly famous Marcellus Shale formation, one of the world's largest accessible reservoirs of natural gas. Lease prices there have risen from $200 to $2,500 per acre, plus a 12.5% royalty on each well's revenue.

Moreover, Marcellus appears poised to become a frequent and successful drilling site in light of the Obama administration's plan to invest $150 billion in a "clean energy economy" that fosters the development of new energy production technology and creates jobs.

Private equity funds face lingering challenges in determining where to drill for their own version of the Marcellus Shale -- the ever-valuable, ever-scarce, "doable deal" -- particularly as a lack of visibility into portfolio company operating results persists. As middle-market buyout shops continue to mine for legitimate platform companies to purchase and bolt-on acquisition candidates to supplement sagging U.S. sales at existing platform investments, creative alterations in deal-sourcing strategies will be critical to finding acquisition-oriented footing and direction.

We see progressive fund managing directors challenging the traditional deal "source wells" of informal networks and national investment banks, and pursuing previously under-explored drilling approaches to enhance opportunities for success -- particularly in the areas of relationship-building and refinement of funds' competitive positioning relative to other funds.

On the relationship side, forward-thinking funds are increasingly teaming with regional sell-side brokers. As local bankers with community roots drill deeper for new deals with entrepreneurs and family businesses, funds can identify and work more closely with those offering relationships in regional geographic areas of niche focus with dealflow that meets investing requirements. Funds that develop strategic plans and regular communications with the many smaller, regional investment banks and fully leverage their internal resources to strengthen these relationships will find themselves evaluating a higher number of qualified deals.

Concurrently, we see progressive funds more frequently integrating their sourcing approach with focused, diligent, buy side broker resources offering "hunter-oriented" DNA. Sourcing is a game of numbers and increasingly funds are required to review larger numbers of deals to find "the one."

Operating management team relationships, too, are becoming a more direct conduit to a deal. We see increased reliance on identifying and working with management teams to find a compelling deal, together -- a tactic that ultimately pushes the deal sourcing to the experts with knowledge and relationships to find deals and then to run the portfolio company.

We also expect more funds to tighten intermediary relationship management -- and facilitate improved dealflow -- through formalized response policies that encompass general communication as well as specific efforts to conduct quick pre- and post-LOI due diligence and administrative procedures. Additionally, we see more funds implementing formal communications "sandbox" strategies: continual outreach and monitoring of warm acquisition targets previously rejected, but of possible interest in the future, particularly in 2009 as visibility and leverage (ideally) return to the marketplace.

Several midmarket funds are honing their competitive positioning with international and vertical niche expertise. International markets are a growing source of platform and bolt-on opportunities because funds can no longer make returns primarily through buying inefficient U.S. companies cheaply. Further, funds with core competencies around opening international markets through direct investment, joint venture or franchising can significantly increase long-term portfolio companies' value. However, the ability to develop this core competency is often outside of middle-market buyout funds' skill sets, and may require the addition of expert resources.

Vertical niches offer another fresh source as generalist funds are challenged with increased competition, a more informed seller and limited deal supply. Areas of specific focus allow funds to go deep on knowledge -- and more importantly, relationships -- within vertical industry niches. As these niches increasingly narrow, the financial return potential grows. Funds can demonstrate commitment to and knowledge in a particular vertical niche through focused attention and investment in trade show attendance and advertising in industry trade journals, thus enhancing their value to sellers.

"Our limited partners continue to challenge us regarding generating higher returns, and the tools for charting the course are increasingly limited," confirmed John Shoemaker, managing director at **Milestone Partners**. "Innovation and creativity must become core strengths in order to generate quality deal opportunities in this environment."

It's time to apply private equity's version of hydraulic fracturing, a drilling innovation that optimizes natural gas production by creating or restoring spaces in a formation to provide a conductive path for natural gas to flow from the reservoir to the well. With similarly creative approaches to stimulating deal production, the conductive path for returns to flow can be expanded.

Thomas Bonney is the founder and managing director of CMF Associates LLC.