Q2 2018

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Dealmaker Roundup

▶ Q1 2018 Review

Featured Topics

- Return of the Mega-Deals
- Add-On Golden Era

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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.

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About the experts

Jesse Fahy is the manager of Venture Capital Data at Preqin, where he leads a team responsible for collecting and disseminating detailed data on fund managers, fund performance, limited partners, fundraising, deals and exits, service providers, and fund terms and conditions. Jesse's research and analysis on the venture capital space is consistently referenced by leading financial press such as *Bloomberg*, *Financial Times*, *The Wall Street Journal*, and more. Prior to this role, Jesse was one of the founding members of the Hedge Fund Performance Team.
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 US LLP 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

Return of the Mega-Deals

Not a moment too soon, Q1 saw the rise of $1 billion-plus private equity deals, finally putting a dent in mountains of dry powder

In a recent conversation, two veterans of the private equity deal landscape discussed recent activity levels, as well as key trends in the market. Excerpts are below:

Privcap: We have the Preqin numbers in from the first quarter of 2018. Interestingly, the number of private equity deals worth more than a billion dollars, so-called megadeals, was up in a big way. There were 24 private-equity-backed megadeals.

Jesse Fahy, Preqin: We've all been waiting to see these large deals come to fruition. We've been seeing dry powder stack up year after year. We've surpassed the $1 trillion threshold, so clearly there's a lot of capital put to work, and it's exciting to see it finally moving out.

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Private Equity Deal Value ($B)

Source: Preqin

Michael Fanelli, RSM US LLP: The deal market continues to be hot. We've just been waiting to see these large-cap deals happen, though. We've been talking about dry powder both in private equity and all the cash on the large-cap balance sheets. I think we saw a lot of activity at the end of last year, but it didn't come to fruition in terms of closed deals or announced deals.

I wonder if the recent U.S. tax reforms made an impact on the willingness of parties to close deals.

Fanelli: The sentiment seems to be really high. In our middle-market business index, which is the tier below the deals we're talking about right now, the CEO sentiment is really high, probably at the highest it's been in the last couple years. A lot of that is due to tax reform, a lot of it is due to expected lower regulation. I think finally CEOs and shareholders are saying, "Yeah, this is the time. Let's put our capital to work." There's a little bit of pent-up supply, and now there's finally willingness on the seller's side, too, to come together.

Fahy: If you look at 2017 from Q1 to Q3, we were on pace for a record year, post-recession. Then Q4 saw that taper off as questions arose over what the tax code would end up looking like.

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–Jesse Fahy, Preqin

"There's a little bit of pent-up supply, and now there's finally willingness on the seller's side, too, to come together."

–Michael Fanelli, RSM US LLP

Fanelli: Uncertainty is the one thing that can kill all deals. Once some of the uncertainty was removed, we saw a big path forward.

Are market participants still worried about the high valuations?

Fanelli: They're still worried. On the large-cap side, organic growth has been good but not great, and so probably some of the pent-up demand in terms of larger-cap deals is partially because they are seeing a little bit of slower growth than expected, and to get some of the growth, they're buying it.

Fahy: Preqin performs a fund manager survey every year, and in that survey one of the questions they ask is "What is the biggest challenge you see facing the private equity industry?" Two-thirds of respondents replied that valuation was the single biggest challenge they see facing the industry.

Of course, as valuations continue to rise, private equity exit activity continues to fall. The Q1 numbers show that exits have fallen yet again. You'd think that in a world of frothy, irrational valuations, people would be trying to sell everything that's not nailed to the floor.

Fahy: Interestingly, as exits are moving down, one thing that has been rising is the sale of portfolio companies to other GPs.

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Add-On Golden Era

Privcap: Let's talk about the fact that we are in one of the biggest deal booms in the history of private equity, but it's important to characterize what kind of deals are getting done. By and large, these are add-on acquisitions. In the first quarter of 2018, there were 357 platform acquisitions by private equity firms, but there were 436 add-on acquisitions. It seems like we're in a golden era of add-ons…

Michael Fanelli, RSM US LLP: There is a lack of supply of good quality middle-market businesses available for sale. I don't think there are enough of them for the global private equity marketplace to invest in and to capitalize on. There is also significant fragmentation throughout these industries. Private equity firms are coming in, buying a nice platform company and then saying, "OK, the growth prospects for this are 5 percent per year, that's good, not great." But if they're in a significantly fragmented industry and they can do 20 add-ons in five years, the platform might have cost 10 times to 12 times EBITDA, but the add-ons are going to cost 6X. You get the multiple arbitrage, as well as less worry about valuations.

It's one thing to do an acquisition — that's kind of the fun part. The hard part is actually getting these different companies to merge and to operate together in an efficient way. What tends to gum up the works from your perspective when trying to make that happen?

Fanelli: It's one of the biggest challenges. It's the thing that nobody talks about. We keep on talking about add-on acquisitions, which inherently is a merger integration process. Post-closing, if it's a $200 million company adding on a $10 million company, maybe it's a little bit easier because the $10 million company basically just does whatever the $200 million company says. But if it's a slightly larger add-on, or if you do multiple $10 million to $20 million add-ons, it's a huge challenge. We always look at as three legs of the stool: There's the people, the processes, and the technology. Those are kind of three of the main points of an integration plan post-closing. And we've seen one or all of them go poorly post-closing. The professionals at the private equity firm are highly intelligent, highly experienced, and they can do the work partially themselves. But they don't have the arms and legs — they tend to be very lean. What they end up doing is bringing operating executives into the deals post-closing, sometimes even pre-closing. And those sometimes are part-time individuals, sometimes full-time individuals.

The deal market has become highly competitive. How are GPs seeking to stand out, other than paying the highest prices?

Fanelli: We see this auction situation on a weekly basis. If you take price out of the equation, I would say there's kind of three things GPs do to win. If it's an add-on, they're bringing their platform company to the table and saying, "we're all in this together, talk to the platform executive management team, this is one big family," etc.

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The other way is bringing in an operating executive to truly help the business increase their top line, or increase their operating margins in a way that they would not have been able to do on their own. The other thing is speed. I had a call with a seller a couple of weeks ago, who told me: "Valuation is important to us, but not the most important. Speed and certainty to close is the most important." If you can close within 60 days and with certainty, that's what's going to be the most important to some sellers. Obviously you have to pay a fair price, but you can beat out somebody who's paying a higher price in that instance.

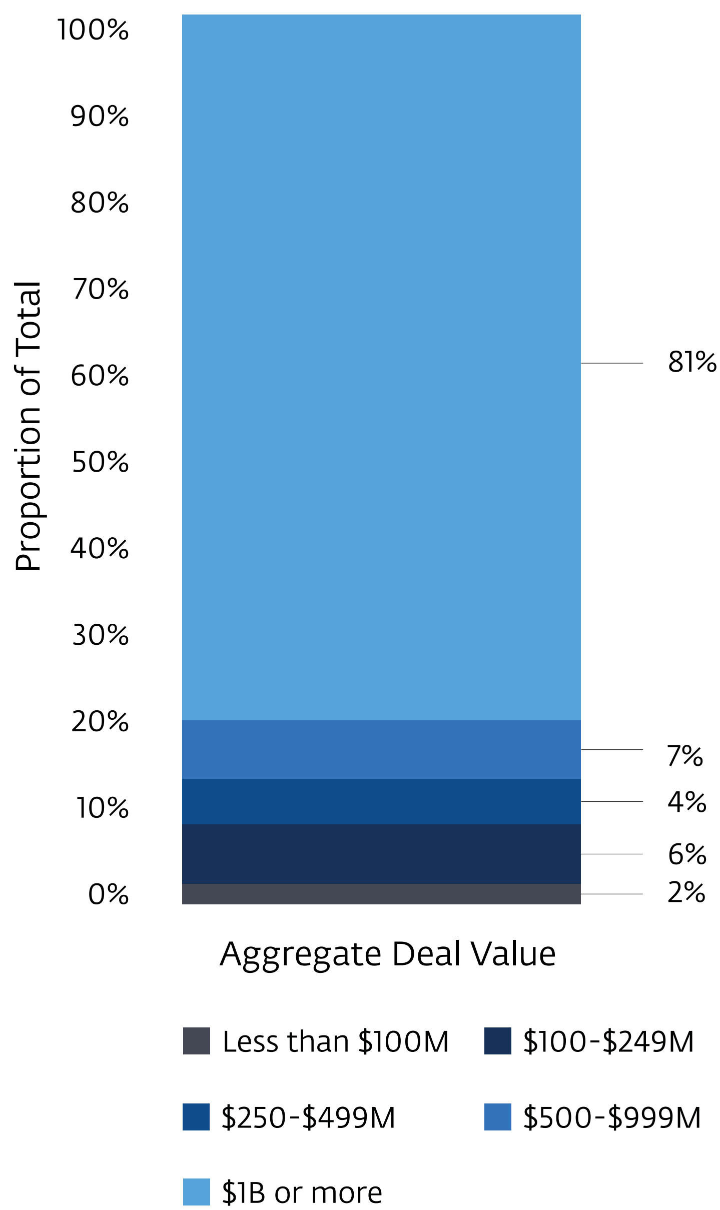
Final question — Jesse, you spend a lot of time gathering data on the venture capital industry. What is going on there that is notable?

Jesse Fahy, Preqin: The venture capital market is actually kind of mirroring the buyouts market in that we see a continuing scaling of the size of their funds and deals. Some people call it the SoftBank effect. Obviously when you raise a $100-billion fund [as Softbank did], many things will go haywire. We're seeing all these name-brand VC firms raise the largest funds in their history. Sequoia has raised a multi-billion-dollar fund, NEA has done it. We're seeing more and more firms scale up so they can compete with these huge bite-sizes of deals.

It's worth noting that in the run-up to the peak of the dot-com era in 2000, the venture capital market was filled with very large venture capital funds raised by firms that had historically raised much smaller funds. And so, on the one hand, maybe VCs today are responding to market dynamics; on the other hand, maybe we're headed for the bursting of a bubble.

Fahy: Now you've just jinxed it. ■

Q1 2018 PE Deal Value, by Value Band



Source: Preqin