SPECIALTY BUY-SIDE SEARCH SERVICES HELP INVESTORS GAIN EDGE DURING AN ECONOMIC DOWNTURN

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Over the past few years, there has been a Mardi Gras among private equity investors, lenders and owners of private businesses who have all been riding the wave of a strong economy. Strong trailing growth rates, availability of high leverage multiples and plenty of equity capital (due to a proliferation of private equity funds of all shapes and sizes) have conspired to provide private middle market companies the liquidity that used to come only with public offerings. With that liquidity, has come purchase price multiples that were heretofore seen only in the public market. Now, fast forwarding to 2008, we have a mortgage crisis that has been a leading indicator for a real estate downturn, a bearish stock market, declining consumer spending and substantial uncertainty about the economy over the next few years. On the tail of what some might call easy money, it is time for the quality investors to step to the front of the class. But, what are private equity firms to do? Sitting on the sidelines, while collecting management fees, will not be understood by limited partners as an effective strategy.

WHO ARE THE SELLERS AND WHY ARE THEY SELLING?

Sell-side brokers have also reaped a bonanza over the past few years as baby-boomer owners of private companies realized that the train was “in the station” and that there may never be a better time to sell before their dotage. Consequently, there was a plethora of product for the private equity firms to evaluate for their portfolios. Deal flow is the life blood of a private equity firm and they have been swimming in it. Investment banks enthusiastic about bountiful success fees scoured the countryside for businesses with the characteristics for an easy sale to private equity. Convincing owners to sell was relatively easy when all they had to do was point to historically high multiples to entice their sellers. Things will change in 2008. It will become harder to believe optimistic growth forecasts for most businesses. Leverage multiples have and will continue to decline, while equity will no longer go as far as it did in the past. In this environment, investment returns will necessarily shrivel. To add to the structural difficulties, deals will become scarce. Owners of private businesses will be reluctant to sell in a “down market” and will look to the future recovery to sell their businesses. Sell-side brokers will still uncover some of the better deals, but there will be fewer of them while the number of buyers remains the same. Supply and demand says that competition will be fierce for those “gems” in the marketplace marketed by the larger middle market investment banks. Other than the “gems”, the sellers will be owners of those businesses that cannot afford to wait for the next cycle, oftentimes because they are concerned about the future prospects of the business and they want to try to squeeze a good price based on their trailing numbers.

WHERE ARE THE QUALITY SELLERS IN 2008?

The hard to find transactions will be for those sellers who are not motivated solely by price or the fear that the future will not be as good as the past. These quality sellers are motivated by strategic reasons, rather than price or fear. Strategic reasons for a sale, such as a need for growth capital or the desire to combine with a larger entity to expand into different markets, are music to the ears of discerning buyers. In 2008, the best opportunities will be among this group of strategic sellers. Oftentimes they will not be focused on selling, rather they will be looking forward to building their businesses and preparing for a changing economy. They will not be receptive to “the time is now” sales pitch of sell-side investment banks. Instead, they will be much more likely to respond to discussions about strategic partnerships and alternatives that can evolve towards discussions of merger or acquisition. It is for these reasons experts believe the best deals in 2008 will be strategic “add-on” transactions, rather than platform-company deals. Strategic “add-ons” not only have the advantage of improving and strengthening existing platform portfolio companies, but they can often be financed under existing banking arrangements, rather than relying on a new lending relationship. The problem for private equity firms will be how to find these strategic sellers before they are located by other potential buyers. It will no longer be enough to wait for the mail to bring a pile of executive summaries touting sellers from far and wide.

HOW TO FIND THE SELLERS AND CLOSE GOOD DEALS

In the early years of private equity, investors who prided themselves on their extensive "rolodex" or "outlook" would never consider engaging a buy-side broker to increase their odds of finding the right deal. Indeed, many even refused to pay buy-side fees when a broker proposed to bring them a deal. But, as private equity firms proliferated and the middle market brokerage industry matured more and more firms tried to gain an edge on their competitors by encouraging brokers to show them opportunities. Now it is commonplace to see special sections of private equity fund websites touting their eagerness to provide brokers with buy-side fees. Recently, firms have been hiring business development personnel to stimulate deal flow, but it is impractical for them to staff up sufficiently with full-time prospecting employees.

As we move into 2008, the competition for the good deals will become fiercer. Many have turned to outsourcing their prospect generation and deal origination services. To gain an edge on their competitors they hire specialty buy-side firms that have industry expertise and systematic protocols for unearthing the strategic prospects that would not otherwise be visible to the private equity community through the sell-side broker network. Utilizing these buy-side specialty firms will become increasingly important if private equity firms want to buy good companies at fair prices. Prospects generated by these firms have the added advantage of not being subject to an auction process and will give the buyer a de facto period of exclusivity to negotiate deals rather than bid on them.

It is likely that the question will no longer be whether to outsource some portion of a firm's deal generation services, but to whom. The companies providing this service range from single-man shops to larger call-center operations, utilizing energetic cold-callers, who oftentimes have little business experience. Many investment banks say they offer this service, but do not have the protocols in place or the personnel to do it effectively. At a minimum, clients should insist upon prospect generation services that utilize sophisticated database capabilities and callers that have sufficient business experience to help convince the quality sellers that they are calling to offer them an interesting strategic alternative for getting through a potentially difficult economic period. With experienced business people calling on their behalf, a private equity firm or its portfolio company has a much better likelihood of completing a transaction. First impressions are just as important in business, as they are at cocktail parties. In addition, having veteran business people who can "talk shop" with prospects will substantially reduce the chances that the searching firm will get a bad reputation within the market niche being blanketed for prospects.

SUMMARY

The future of private equity remains bright for those firms that acknowledge that the landscape for deal flow generation is changing. Those firms that refuse to change ways of deal generation will experience a drying up of deal flow and a unhealthy reliance on competitive deals that will sell at prices inappropriate for the present economic reality. No longer will there be a steady stream of attractive companies selling because multiples are at historic highs. Instead, quality sellers will have to be coaxed into selling for strategic reasons. To accomplish this, it behooves progressive investors to outsource the prospect generation part of the deal pipeline and focus full-time employees on the process of convincing quality sellers to sell, performing market due diligence and negotiating deal prices and structures.

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