Paul|Weiss

Private Equity Digest

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New Trends in Private Equity Transactions

The private equity market is more competitive than ever. Target company multiples have skyrocketed due to both a robust strategic acquisition market, and stiff competition from PE buyers as they vie with one another to deploy $1 trillion in dry powder that remains from the $3 trillion raised in the past five years.[1] As traditional investment strategies become more challenging, PE firms are adopting innovative strategies to adapt.

In this issue of the Private Equity Digest, we look at four methods PE firms have used to adapt to the current competitive environment – (i) engaging in more buy-and-build approaches or add-on acquisitions, (ii) investing in early-stage companies, (iii) holding companies for longer periods and (iv) acting as lenders.

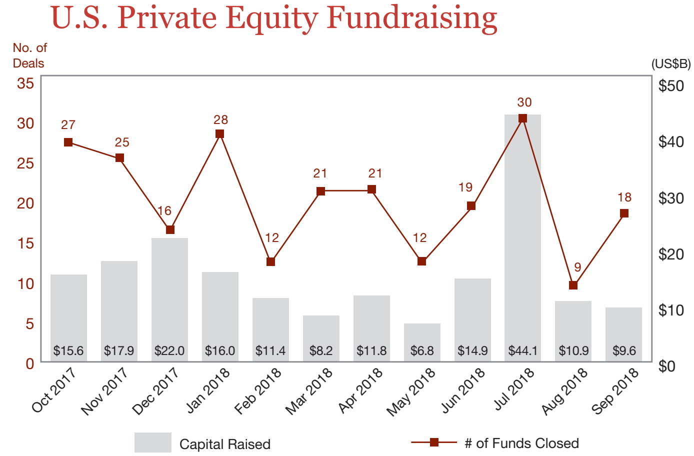
Engaging in Buy-and-Build or Add-On Acquisitions

The number of funds making add-on acquisitions in a given year has increased by around 50% since the early 2000s,[2] as PE firms look for opportunities in increasingly fragmented sectors. Reports indicate that buy-and-build and/or add-on transactions accounted for 70% of all PE buyouts during 1Q 2018.[3] Moreover, there is evidence that across most vintages, PE funds that make more add-on acquisitions yield greater cash-on-cash returns.[4]

There are numerous benefits to buy-and-build and add-on strategies. By merging small companies, PE groups drive top-line growth by accessing new customers and markets. This strategy also brings down purchase price multiples because small companies tend to trade at lower multiples than platform acquisitions and because PE firms may be able to take advantage of imperfect information in the smaller company market or industry. PE firms can further improve margins by pooling operational expenses and taking advantage of increased buying power to bargain for reduced input costs across investments. The strategy of accelerating portfolio companies' growth by acquisition enables PE firms to achieve synergies much like strategic players, which have also had to look beyond organic growth to M&A strategies for revenue or other expansion. Finally, buy-and-build and add-on acquisitions allow PE managers to create unique business combinations, with newly employed operations specialists commonly aiding the integration of subsequent acquisitions.

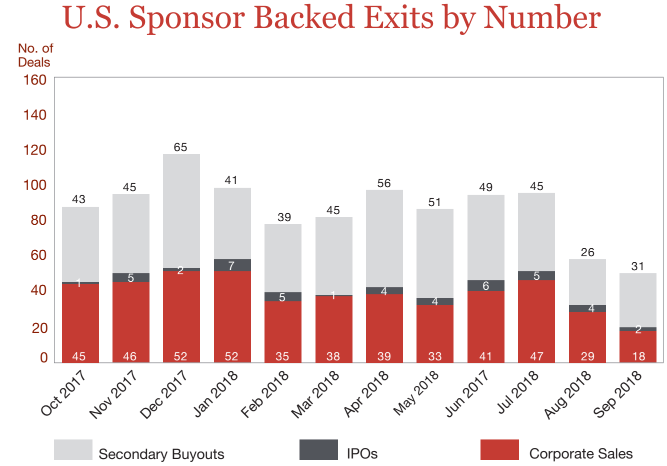
PE firms will, however, need to develop expertise and infrastructure to address issues more typical of strategic deals, such as antitrust clearance and cultural integration, which arise more often in buy-and-build and add-on acquisitions as compared to the typical financial buyer deal.

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor Backed Exits by Number



Source: Pitchbook

Investing in Early-Stage Companies

Historically, PE firms generally sought out the largest companies supportable by their fund structures because increased scale provides more potential for transformative impact and related higher returns. Recently, however, PE firms have diversified their investments by buying more middle-market companies. Also, some PE firms have concurrently been focusing on earlier-stage companies, blurring the lines between private equity and venture capital.

In 2017, PE firms across the United States invested an all-time high of $346.3 billion in a record number of 2,509 middle-market transactions.[5] Further, companies with venture capital funding accounted for 3.7% of PE buyouts by mid-2018,[6] and $8.5 billion worth of transactions in 2Q 2018 involved PE investors in the venture capital market, showcasing a new willingness by PE firms to invest in early-stage companies.[7] PE firms are also increasingly looking at fledgling industries where start-ups are common, such as software, fintech and cannabis.

Similar to buy-and-build and add-on strategies, buying earlier stage companies allow private equity firms to take advantage of developing markets and informational imperfections to find suitable targets.

Holding Companies for Longer Periods

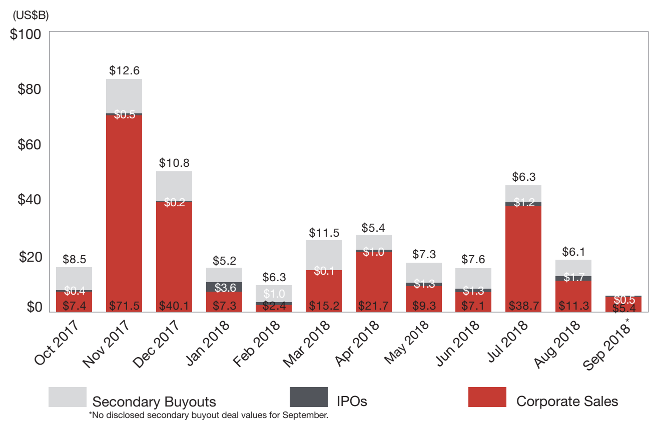
Average holding periods for US-based companies by PE firms have increased over the past ten years. Traditionally, PE firms' hold period was 3-5 years, and during the industry's pre-2007 crisis peak, PE firms were flipping nearly 40% of companies in fewer than three years.[8] According to Preqin data, average holding periods are now on the higher end of that range at approximately five years (after reaching a high of six years in 2014).

There are several potential benefits to holding companies longer. Less frequent exits mean more flexible exit options to maximize sale price, fewer recurring costs for the funds and the LPs that invest in them (including the costs of fundraises) and less time spent screening new investment opportunities.

Further, the trend of longer holding periods is attributable at least in part to the increase in buy-and-build or add-on strategies and investments in younger companies, which take longer to mature to exit. With buy-and-build or add-on strategies, the longer holding period is due to the additional time needed to acquire add-ons and integrate them into platform companies.

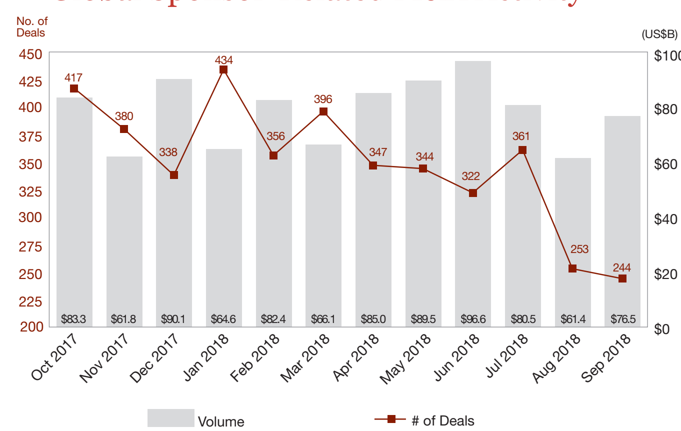
The trend of longer holding periods is also attributable to an increase in fund-to-fund transfers inside fund complexes, which allow PE firms to continue to build platforms over longer periods, while simultaneously allowing LPs to cash out prior to exit.

U.S. Sponsor Backed Exits by Dollar Volume



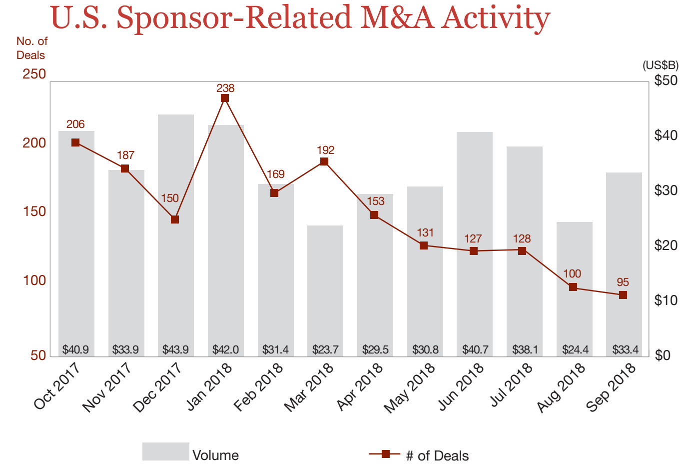
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

Each metric in this publication that references deal volume by dollar value is calculated from the subset of the total number of deals that includes a disclosed deal value.

Acting as Lenders

Non-banks, including many PE firms, held more than half a trillion dollars in loans to midsize companies at the end of 2017, up from $300 billion in 2012. According to Preqin, firms raised 322 credit funds between 2013 and 2017, with 71 funds being raised by firms that had not raised a credit fund before.

PE firms are increasingly using their historically high cash balances to compete with banks to lend directly to midsize companies. Less highly regulated than banks, PE firms are able to finance deals eschewed by traditional lenders. For their part, PE firms are looking to direct lending to earn better yields than traditional bonds and treasuries, which have been hampered by low interest rates. PE firms regularly finance competitors' deals and some even fund their own buyouts.

Takeaway

As PE firms continue to raise larger funds and sit on greater sums of dry powder, competition in the market is growing more and more fierce. As a result, it has never been more important for PE firms to look beyond traditional models to new strategies for growth. Engaging in buy-and-build or add-on acquisitions, investing in early-stage companies, holding companies for longer periods and raising credit funds are all ways in which PE firms are adapting to the current market, with more cutting-edge developments sure to unfold over the short term.

1 Bain & Company Global Private Equity Report 2018; Preqin 2018 Global Private Equity & Venture Capital Report.

2 PitchBook 3Q 2018 Analyst Note: Additive Dealmaking: Part II: An analysis of add-ons' effect on fund performance.

3 Pitchbook 2Q 2018 Private Market PlayBook.

4 PitchBook 3Q 2018 Analyst Note: Additive Dealmaking: Part II: An analysis of add-ons' effect on fund performance.

5 Pitchbook 2Q 2018 US PE Middle Market Report.

6 Pitchbook 2018 Private Equity Outlook: 1H Follow-Up.

7 Pitchbook 2Q 2018 Private Market PlayBook.

8 Bain & Company Global Private Equity Report 2018.

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