2018 Forecast: 5 Major Trends Hitting the Middle Market

By Danielle Fugazy Author at Axial

Trend 4: Blurring the Lines

Where private equity started and growth capital or venture capital ended used to be easily defined. However, times are changing. Once again as a way to gain a competitive advantage in today's very competitive market many firms have changed their investment approach. In days past, firms that were once generalist firms—pouring over deals in various sectors—soon became sector focused firms— touting their in-depth knowledge of a particular sector in hopes of impressing potential targets. Now, some control buyout firms—that were positioned as firms that would only complete deals where they could take a majority ownership interest—have changed their tune. **An increasing number of firms are now interested in pursuing growth equity deals as well.** For example, at the end of December, Apax Partners closed on $1 billion for investment in growth-stage technology companies. The new fund will target minority and buyout investments in enterprise-technology and consumer Internet companies worldwide, aiming to deploy $30 million to $150 million of equity per deal.

Other buyout firms have recently done the same as Apax. For example, KKR & Co. secured $711 million for growth-equity investments in the technology, media and telecommunications sector in North America, Europe, and Israel. Middle market firms are also getting in on the action. **Firms like The Riverside Company, Huron Capital, and Balance Point Equity have all diversified to be more inclusive of various deal terms allowing them to cast their deal sourcing net much wider**.

In 2017, Huron became more formalized about their non-control investment. In August, the Detroit, Michigan-based firm did its first non-control equity deal in Stay Online out of Huron Flex Equity. "There is blurring between equity and growth equity. A non-control equity strategy can help a company grow faster than it could on its own. We started our formal non-control strategy in 2017 and the market has received it very well. It fills a hole in the market for businesses that would like a partner with firms that have access to operational resources and capital, but aren't quite ready to give up all the control yet," says Perkins.

According to Probitas Partners latest Private Equity Institutional Investor Trends for 2018 Survey, investing in growth capital funds is only behind U.S. middle market buyout funds and U.S. small market buyout funds as the sector of most interest among limited partners in 2018. "We have seen more and more growth capital over the past 10 years and that should continue. LPs are a lot more accepting of this strategy today because there is now a history of success," says DePonte, who adds that investors now accept that if the proper negative controls are in place that you don't need total control to be successful.

In addition to expanding investment opportunities, investing growth capital doesn't rely on leverage, which can also be attractive.

As the lower end of the scale, there is a blurring line between late-stage VC and growth capital as well, but this really depends on sectors and is most likely to impact sectors like tech and life sciences, says DePonte.

Balance Point Capital, invests both debt and equity into lower middle market firms. "We have pivoted to this model very much so. It's a way to get money out the door into a company. Your upside may be limited, but this approach is designed to protect your downside, which is nice at a time when valuations are so insane," says Kaplan. "Flexibility is key."

Trend 5: Tax Legislation Impacts Next Move

While the new tax legislation is going to vote as we go to press with this report, it's safe to say there will be positives and negatives for businesses, private equity firms and consumers.

The proposed bill will only allow companies to deduct corporate interests on up to 30% EBITDA for the first 4 years and then 30% EBIT afterwards. This is a big change from the current 100% deductibility of interest. Because of their reliance on leverage private equity firms would be hurt by not being able to deduct interest expense from their portfolio companies' taxable income. "There is a reason these deals are called leveraged buyouts. They rely on the tax shield to enhance returns. This change will be a huge issue for non-traditional bank lenders. They are going to have to figure out new ways to do business," says Burkhart.

On the other hand, DePonte argues that less reliance on leverage wouldn't be so bad for the private equity business. "Tax law could drive private equity firms to focus more on making companies better than on using leverage to drive returns," he says, acknowledging that the industry have been increasingly focused on making improvements rather than financial engineering in recent years.

The latest bill also proposes that carry at private equity funds continue to be treated as a capital gain if those investments are held longer than 3 years, a longer timeline than the one year threshold currently applied. "Right now, the outcome is looking more like a 3-year holding period for long term capital gains treatment," says Perkins, who is very involved in lobbying efforts on the half of the private equity industry via the Association for Corporate Growth Public Policy Committee.

Additionally, it seems that their portfolio companies could have more money as a result of cutting the corporate tax rate from 35% to 21%. Some feel this will make American businesses more competitive with companies abroad.

"We are already talking to our companies about what we will do with the extra cash, which is a good thing. It will allow us to reinvest the rest in the business," says Kaplan.