2018 Forecast: 5 Major Trends Hitting the Middle Market

By Danielle Fugazy Author at Axial

Trend 1: The Evolution of Deal Sourcing

High levels of dry powder have put more pressure on fund managers to put capital to work, a danger in a market where purchase price multiples are high. To put things into perspective, over the past four years, the dry powder has expanded considerably above the 2007/2008 previous peak in North America and Europe, according to Probitas Partners. What's more, fundraising numbers and dry powder statistics are likely underestimated. "Traditional funds are being tracked, but more frequently LPs are co-investing and setting up separate accounts. Those are private arrangements and are not tracked. There is tremendous pressure on the market. It's going to continue to be hard to make good investments," says Kelly DePonte, a managing director with Probitas Partners.

With this in mind, there has been tremendous growth in the business development role. Over the years private equity firms have realized that it's not efficient to have dealmakers sourcing deals and that someone needs to be dedicated to the job if a firm intends to stay around. More and more private equity firms are hiring business development professionals at the partner level.

Balance Point Capital Partners is in the process of engaging a dedicated business development professional to help with deal flow and the strategy is proving to be successful. "The days of a "jack of all trades" model is a tougher model for firms of scale," says Justin Kaplan, a partner with Balance Point Capital Partners.
Firms like Orix Capital Partners, Platte River Equity and Turnspire Capital Partners just recently hired business development professionals while firms like Audax Partners, TA Associates and Summit Partners led the charge with having these types of professionals on staff. Perhaps it's not surprise that these firms usually close on a relatively high number of deals annually. In fact, Audax Group, TA Associates and Summit are almost always counted among the most active investors by deal count, according to Pitchbook numbers.

"As the private equity industry matures, deal sourcing has become a significantly greater focus of most firms. Many have had success with junior level staff, but most firms seem to have turned to senior level talent to fill the business development role," says Dan Lipson, a partner with Rotunda Capital, an independent sponsor that raises funds on a deal-by-deal basis.

In addition to using more senior professionals, the next generation of business development professionals are more frequently using technology to be more efficient. "We look at 700 deals a year and we close on about 15. Using technology is imperative," says Joseph Burkhart, a managing director with Saratoga Partners. "I turn down 99 percent of the deals I see, but I send multiple opportunities to others. People remember this," he says.

Trend 2: Technology Moves Private Capital Markets Forward

The bottleneck of almost every private equity firm is sourcing. It's getting more competitive to get deals done and the competition continues to grow. All dealmakers are looking for ways to stay ahead of the competition. Some are hoping technology could be the answer.
2018 should see increased budgets for data monitoring and deal sourcing tools. The Boston Consulting Group recently highlighted a few segment leaders, including the business development network from Axial, customer experience analytics from Klear, and social media monitoring tools from Crimson Hexagon. Given the slow-to-change M&A market, companies like Axial are bridging both the online and offline worlds. The company uses proprietary data and algorithms to curate connections between investors and advisors at regional and national events in addition to its online platform.

Firms like Balance Point are using technology to get very precise, detailed information on firms they are calling on. "Most firms have a CRM, but companies like SourceScrub and Sutton Media have popped up and can be integrated into the CRM giving us more access to our contacts' deal process. For example, we are able to see the last five deals a bank did and who they did them with. If we weren't called we want to know why," says Kaplan. "It's no longer just call on these guys. It's more specific, which is helpful."

Rotunda has begun looking into technology that can help portfolio companies track the sites that customers looked at after they looked at the portfolio companies' site. "We are in the beginning stages of evaluation of this technology, but believe it could help us narrowly define our competitor set and help us prioritize acquisition targets," says Lipson.

Gretchen Perkins, a partner with Huron Capital Partners, agrees that the use of technology has grown all in the name of finding the right deal flow. "Firms are spending real dollars on robust CRMs and there are definitely more deal listing services. It's good for the industry in terms of making it easier to see more deals than you could before, but it can exacerbate an already competitive situation," she says.

GPs are also trying to drive deal flow by using social media channels to extend their outreach. While it's hard to quantify the potential impact of using social media, dealmakers are willing to try anything reasonable to gain the upper hand today. "If we can properly target companies using social media that would be extremely helpful. The more progressive firms are moving in this direction," says Perkins.

Burkhart, who has started a blog discussing different topics around private equity and sourcing, says this has actually brought him deal flow. "My blog is read by more than 7,000 people and my phone rings because people view me as an expert. They ask me questions and it leads to relationships. It's a warm lead versus the old school way where you hire junior people to bang the phones. You have to be viewed as a decision maker and expert to be taken seriously these days," says Burkhart.

Trend 3: Limited Partners Becoming Full Fledged GPs

The concept of limited partners investing directly is not new. Of course, limited partners (LPs) in Canada like the Ontario Teacher' Pension Plan and Canadian Pension Plan Investment Board have always invested directly into companies to gain better economics. A few years ago, family offices increasingly began to invest directly, and today, traditional limited partners and financial advisory firms are looking to invest directly. For example, The California Public Employees' Retirement System (CalPERS) is weighing its options. During the summer, the $323 billion pension fund said it would explore a direct investment program. CalPERS is the largest pension fund in the U.S. and private equity has been its best performing asset class for two decades, but still, the pension fund has faced criticism for paying high fees, which led the pension fund to review new strategies including investing directly.

"They are looking to avoid the 2 and 20, which is understandable. We have seen this in the past, but what many have found is that it's hard to manage growth at the company level and some LPs just don't have the experience of having been the control investor," says Perkins.

While CalPERS and other larger pension firm and endowments rethink their investment strategies, money managers are doing the same. Baltimore-based Brown Advisory, for example, will pool together client funds to meet minimum LP requirements in larger funds as well as allow clients to diversify LP holdings. In addition, Brown will, on occasion, use pooled investor funds to directly invest into companies. In many circumstances, these investment opportunities have been sourced from their client base.

"We are seeing a lot of innovative structures from family offices and high-net-worth looking to invest in our deals," says Lipson. "

There is a real desire from LPs to invest in the private equity sector outside of the traditional LP/GP fund structure."

While the advantages seem clear of course there are challenges. "As alternative GP vehicles get created to fund one-off deals, LPs still need to underwrite the investment manager and get comfortable that the GP has the experience and expertise to create equity value. Private equity investing still requires a significant amount of active management," says Lipson. LPs interested in becoming GPs will have to build out management teams to generate proper returns and that may prove difficult. "Senior management at certain large pensions do not seem to understand that there are huge differences in properly executing a direct private equity investment program and managing a publicly traded equity portfolio. Private equity is the ultimate active investment strategy, requiring the ability to not only target and purchase companies at the right price but also to oversee the management of a company at a detailed level and then properly direct an exit. To be successful they will have to make the commitment to hiring experienced private equity professionals – and retain them," says DePonte. LPs going direct are less likely to impact the lower middle market because of how difficult it is to access. "We actually see the opposite. We have LPs coming to us saying you know the lower middle market and we don't have the resources or the know how to access it. Can you help us?" says Kaplan.

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