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PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
FALL 2015

Thoughts From the Combat Zone

Observations from the annual Growth Financing Conference.

by Mark Working

In July, the Association for Corporate Growth held its annual Growth Financing Conference in Seattle. The Conference is attended mostly by investment and mergers and acquisitions deal professionals, including private equity investors, mezzanine providers, senior lenders of various stripes, lawyers, accountants, and investment bankers. We took the opportunity to test our own observations of the current middle market private equity and credit markets with those of other deal professionals from around the country. Although not a consensus on all fronts, there were common themes among the participants.

Deal volume is average in quantity and above average in quality. As reinforced by most published deal data, deal volume is robust, but not frantic. That being said, good companies are coming to market. Equity firms

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are pleased with the quality of the businesses. Private equity firms expressed varying degrees of "busyness", but none indicated they were flooded or unable to respond to new opportunities. A common theme was that larger equity firms were "coming down market", primarily because there aren't enough deals of size to absorb their time and attention. This added focus on high quality middle market opportunities has created even more competition for each, leading to equity firms doing more front-end work in a sale process in order to compete and win deals. In some cases, due diligence, including quality of earnings studies, are being completed prior to final bids.

Prices are high, maybe reaching a peak? Competition leads to best efforts pricing and that is definitely showing up in sales processes. Every private equity investor had stories to tell of the deals they lost even though they broke all of their valuation limit rules. As discussed in the nearby article, "Growth, Leverage and Multiples", there is considerable pressure to

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put capital to work and plenty of evidence that valuation standards are being revised in order to win deals.

Several friends in the industry expressed concern over how this environment is changing the nature of private equity – from investors to asset allocators. Most private equity funds are structured such that limited partners are guaranteed a priority return, usually around 8% per annum. This return comes after recovering all management fees, usually 2% per annum on committed capital, which increases the hurdle for return on actual invested capital before managers of the fund begin to share in the gains. With prices on quality companies receiving prices equal to 10x,

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or more, of EBITDA, earning a carried interest becomes more challenging.

Not all companies are created equal. Everyone wants to talk about the high-multiple transactions, but there is actually a wide multiple range in which private transactions occur. The "averages" are being heavily skewed upwards by companies operating in markets where there is observable growth. It is investments in those companies where an opportunity to earn a higher return exists. Companies that have a perceived growth trajectory, especially those who operate in a market segment that exhibits natural growth characteristics, offer opportunities for investors to build bigger more valuable businesses. Achieving growth, and all the economic benefits that flow from it, is not without risk. Organizations will become more complex, new people, equipment, and facilities will need to be absorbed thereby altering the culture, and systems will need to expand and become more sophisticated. But, if everything goes well, great rewards in profitability and value can be achieved. Growth prospects and

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leverage each contribute to buyers being able to pay higher prices. When mixed with a competitive environment, very high (historically, speaking) multiples of EBITDA are possible.

Debt is plentiful and cheap. Lenders funding private equity acquisitions are pushing the envelope in terms of historical debt-to-cash flow multiples. Previously reserved for much larger companies with stronger and more diversified market positions, some middle market companies are able to borrow between 4x and 6x cash flow. Banks are generally not, as a result of regulatory limitations, the parties leading the parade, although banks accompanied by mezzanine investors jointly are able to compete in the stratosphere. Non-bank unitranche lenders (often referred to as the shadow banking system) seem to be leading the way in this market. Ultra-high leverage with little or no amortization, even with higher interest rates, offers equity fund

(continued p. 2)

investors the ability to boost their returns.

Capital risk is increasing. Lenders are advancing more than they historically would at lower rates, and equity investors are paying higher prices to participate in growth businesses. Competition is what is driving these conditions. Too much money is chasing too few opportunities. History will tell if this was a wise use of capital. Nevertheless, this tells us that the market for capital, whether to finance a company's growth, recapitalize the ownership structure, or outright sell the business, is strong and cheap. It is a borrowers' and sellers' market. **ZS**

Zachary Scott
TRUSTED ADVISORS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

Michael Black
206.838.5526
mblack@zacharyscott.com

Frank Buhler
206.224.7383
fbuhler@zacharyscott.com

Jeffrey Cleveland
206.838.5521
jcleveland@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Mike Dannenberg
206.838.5531
mdannenberg@zacharyscott.com

William Hanneman
206.224.7381
bhanneman@zacharyscott.com

Michael Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray Rezab
206.224.7386
rrezab@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Shaun Withers
206.838.5529
swithers@zacharyscott.com

Mark Working
206.224.7382
mworking@zacharyscott.com