



Forget Those Big Deals (and Headlines): Private Equity Firms Are Shopping the Middle Market

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Big buyout firms like the Blackstone Group and Kohlberg Kravis Roberts do headline-grabbing transactions and collect eye-popping paychecks. But when the economy slows down and lenders turn wary, those mega-deals are the first to dry up.

Meanwhile, the modest middle market -- typically deals in the \$500 million to \$1 billion range -- keeps plugging along, according to investors who gathered at the 2008 Wharton Private Equity Conference. These transactions may not get talked up on CNBC's "Squawk Box" or written about in *Barron's*, but they also don't depend on the availability of cheap credit and the lending appetite of big banks like Citigroup and Bank of America. In fact, the middle-market specialists who spoke on a panel titled, "Middle Market: Calmer Waters or Sea of Competition?" argued that they are, to some extent, insulated from the current credit crisis and other economic ups and downs.

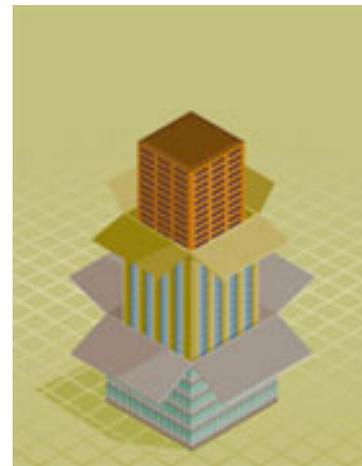
"We're delighted with the credit crunch," said Sean Traynor, a partner at private equity firm Welsh, Carson, Anderson & Stowe in New York. "Despite what's going on with the market and the economy, a lot of the businesses that we look at are still very good businesses. There will be opportunities, certainly, in a distressed world, and recessions don't last forever."

The strong stock market and economy of the last several years had pushed corporate valuations to lofty levels and thus raised the prices that private equity investors had to pay to do deals, said Peter Taft, a Cleveland-based partner with Morgenthaler Partners. Now, valuations are returning to normal. "There was enormous confidence supporting assumptions about valuations," he said. "We're now seeing the market correct, and some of that confidence is collapsing."

Tenser economic times offer a chance to do deeper analysis, Traynor added. When the market is frothy, frenzy sets in, and people want to execute deals quickly -- too quickly sometimes. An economic slowdown can make people, well, slow down. "The greater appetite from lenders for due diligence gives us more time to evaluate deals," he said. "If we have time to do our work, I'm confident that we'll make a good decision."

At present, giant commercial and investment banks like Citigroup, Merrill Lynch and UBS are grappling with losses from subprime mortgages and related securities, and therefore have lost much of their appetite to participate in big buyouts. According to research by U.K.-based Dealogic, which tracks investment activity, mega-deals slowed nearly to a stop in the second half of last year. Deals in the middle market continued, though at a slower pace.

Middle-market transactions are often financed by regional and community banks, which so far haven't been sapped by subprime losses. Many of these banks are still willing to lend, though they have become more cautious. "It takes more creativity to get debt financing today," Traynor noted. And some banks, even healthy ones, have left the buyout business altogether. "This isn't a great business for banks," Taft



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said. "GE Capital is still in the business, but a lot of banks have gotten out of it."

Another advantage of middle-market transactions is that they are frequently driven by considerations other than the current state of the stock and bond markets. Families often own middle-market firms and choose to sell for reasons like succession or estate planning. These considerations aren't as sensitive to economic zigzags. "It's been business as usual for us," said David Simon, managing director of Littlejohn & Co. in Greenwich, Conn. "We closed a transaction in November."

Working Harder in Tough Times

None of this means that middle-market dealmakers won't feel some effects if the economy slows down further, as many forecasters are predicting. Even if middle-market investors manage to maintain their deal flow during a recession, the companies in their portfolios could be hurt by slowing sales, for example. "Middle-market companies are more susceptible to downturns" than giant firms like Microsoft and Exxon Mobil, Simon pointed out. They tend to be less diversified in terms of their product lines and markets, and are therefore less able to compensate for a downturn at home by selling abroad. For middle-market investors, that might mean having to help companies in their portfolio make the transition to selling more products overseas.

"There's a benefit to large size. In the middle market, you have to work harder when things get tough," Simon said.

A key part of any private equity investor's strategy is finding ways to improve the performance of the firms in his portfolio. Taking an average performer and turning it into a star can increase the investor's return during an exit. "We buy companies that are okay operationally but never best-of-breed," Simon noted. "We want to help them achieve operational excellence. We try to transform businesses. We go in with the bias that the company is under-managed ... but also very agile and fragile."

Employing specialists in fields like accounting, marketing and logistics can help diagnose problems and prescribe fixes. "We have arrangements with about 20 executives to help us deal with operational issues," Traynor said. "That can really help us increase the value of companies that we invest in. There are tons of businesses that are under-managed or don't know how to market."

Much attention is lavished on the financing of private equity deals, and critics like to say that all private equity investors really do is buy firms and load them up with debt. But Bruce Eatroff, founding partner of Halyard Capital in New York, argued that operational assistance matters far more than creative financing. "Capital is a commodity," he said. "We'll take advantage of financial engineering if it's available. But you have to bring more depth than that. We show [companies] that we will be a key partner in their business."

Simon agreed, pointing out that when doing a middle-market deal, human resource challenges often outweigh the financial ones. "Everybody can say that they know where we want to go, but inevitably somebody will be rowing strongly in the other direction," he said. To try to ward off these sorts of problems, Taft's firm does a detailed assessment of the skills, strengths and weaknesses of every member of the management teams of the companies that it acquires.

Cross-border Strategies

Perhaps the greatest challenge for middle-market companies is globalization, the panelists said. Mid-sized companies often purchase at least some of their inputs abroad and sell some of their products and services overseas. But in a more globally interconnected economy, they have to do more of that, and they are feeling more competition from foreign firms. "Globalization isn't new, but the pace of change has heightened," Traynor said.

At the same time, booming economies like China and India represent promising opportunities. While they may be perceived as only exporting goods and services to the developed world, they need equipment and expertise, too. "For companies north of \$150 million, you'll find that international markets are a growth strategy," Simon said. "We're seeing a lot of international buyers for products right now because the dollar is so cheap."

Even mid-sized U.S. manufacturers, so frequently written off as dinosaurs, can continue to compete by teaming up with partners from abroad. "We've done a China joint venture with one of our portfolio companies," Taft noted. "And we're starting a China manufacturing company with another."

Not every sector, of course, can take advantage of globalization. Some simply don't lend themselves to exporting or cross-border operations. "We invest in healthcare, and it's an inherently local business that hasn't done a lot of offshoring," Traynor said. "But we have some product-and-service businesses with divisions outside of the U.S. and, with the dollar falling, that's been an area of performance."

Traynor added that he expected private equity firms of all sizes and sector specialties to continue to thrive, especially as they vie with big public firms to buy companies. "We have a real advantage in doing deals and, thanks to our compensation plans, in attracting management," he said. "We can move more quickly than public companies, and we don't have to worry about 10% of the shareholders barking at us. The public company model in the U.S. is broken right now. Companies end up making bad strategic decisions because of structural issues."

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