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BDO PERSPECTIVE

PE FIRMS PLANNING FOR DEAL-SOURCING SUCCESS IN A COMPETITIVE ENVIRONMENT

By Lee Duran and Dan Shea

2015 has been a strong year for merger & acquisition (M&A) activity thus far – at least in the middle market.

According to ***Mergers & Acquisitions***, the first six months of 2015 saw about 1,100 completed deals among the middle market, generating approximately $140 billion in proceeds. If this pace continues, ***Mergers & Acquisitions*** reports, 2015 may be on track to be the best year for middle market deal flow since before the 2008 recession.

Competition to obtain attractive targets continues to grow. Private equity firms are competing not only with each other but also with strategic buyers looking to accelerate growth through M&A. While ***PitchBook*** points out that potential interest rate hikes in the coming months could stabilize valuations, sellers continue to have high expectations and are often not anxious to close a sale. Lots of buyers and few sellers would mean a continuation of the "sellers' market" in place for the last several years.

Separately, limited partners are demanding the fund sponsor deploy its capital and are increasingly interested in co-investing with the sponsor. As such, they are seeking private equity (PE) firms with access to proprietary deals and substantial market coverage that other firms don't have, making it all the more important for PE firms to ensure they maintain strong access to qualified deals.

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DID YOU KNOW...

Fifty-six percent of capital markets executives cite readily available private capital as the leading cause of the decline in IPOs in 2015, according to BDO's 2015 ***IPO Halftime Study***.

PitchBook's ***3Q 2015 U.S. Venture Industry Report*** finds that U.S. venture capital funds have invested $36.9 billion in the first half of 2015. However, deal count is lagging, with 2015 set to be the first year with a decline in VC activity by deal number since 2009.

Amid a challenging deal environment in the U.S., ***Thomson Reuters*** reports that PE funds have been focusing on the middle market this year, with syndicated middle market PE borrowing reaching nearly $12 billion in Q2 2015.

Private equity-backed deals accounted for more than 40 percent of total deal volume in the software sector as of July 2015, says ***The Wall Street Journal***.

According to ***PitchBook***, 410 venture capital investors have completed at least one deal in the healthcare sector since 2011, exceeding $3 billion in total deal value.

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DEAL-SOURCING SUCCESS

So how is a PE buyer to stay ahead of the competition? As it turns out, many are moving away from their traditional patterns and are instead seeking creative deal-sourcing solutions and alternatives. Below are five of the most common ways to beat the deal-sourcing competition – or work around it:

1. **Leveraging a dedicated business development professional.** According to Sutton Place Strategies' 2014 Deal Origination Benchmark Report, some of the highest-performing PE firms employ a business development (BD) professional whose sole responsibility is canvassing the market for qualified targets. In this focused role, the business development lead is theoretically more likely to spot quieter, less flashy – but perhaps more attractive – deals.

2. **Tapping buy-side intermediaries.** As with a business development professional, leveraging a buy-side intermediary has the distinct benefit of providing a resource dedicated primarily to sourcing and closing deals – which goes a step beyond in-house BD resources who typically do not participate in closing the deals they source. These intermediaries are set up to locate qualified targets flying below the radar. They are well-connected and often have vast market coverage. With PE firms only closing a small fraction of the deals they identify, the use of intermediaries can improve their odds by bringing one-off opportunities to their door. Indeed, hiring intermediaries and transaction advisors is becoming increasingly common. The number of intermediary professionals increased by about 12 percent between June 2013 and the same time in 2014, according to the Sutton Place Strategies report.

3. **Specializing in a specific industry or market.** PE firms can differentiate themselves by developing expertise in particular industries, geographies or ownership structures. Researchers claim that two key advantages to specialization are increased certainty in the area of focus, as well as reduced information asymmetries. Focusing on a "sweet spot" where the PE firm is highly experienced and has a history of strong results is appealing to sellers, and creates momentum for continued specialization and enhanced returns.

4. **Focusing on add-ons and other growth strategies.** PE firms are seeing solid prospects in making minority investments in rapidly growing companies, which tend to be less risky investments than more traditional buyouts. Yet in the same vein, we're also seeing growing interest in add-on deals. These complementary activities can bolster PE firms' portfolios even in a challenging environment for opportunities.

5. **Seeking out secondary offerings and carve-outs.** Similarly to add-ons, fund sponsors may be able to find value in entities other PE funds or parent companies are liquidating. Some PE funds have found success in picking up assets whose parent companies are seeking to shed them– whether because the assets are no longer considered core to the business or future growth, or because they are unproductive and non-strategic. While such carve-outs can carry a number of significant risks, an experienced buyer may find in them solid businesses to use as platforms or for add-ons.

6. **Hunting for "older" offerings.** While many firms may hesitate to go after deals that have been on the market for some time, these older deals may in fact be diamonds in the rough, as owners' valuation expectations may become more realistic over time.

PE firms may employ just one of these tactics, or they may use a mix to make the most of their current portfolio and available targets as they scout for "the ideal opportunity." There are advantages and drawbacks to all of these approaches, but competitive PE funds will be willing to experiment to find ways to break away from the rest of the pack – and stay there.

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PRIVATE EQUITY FIRMS: HAVE CSOS' COMPENSATION PLANS EVOLVED WITH YOUR PORTFOLIO COMPANIES?

By Reese Bacon

Private Equity firms are constantly looking for ways to maximize the efficiency and the profitability of their holdings. But one often-overlooked but high-impact consideration is whether their portfolio companies are structuring their chief sales officer's (CSO) compensation plan properly – or if that plan needs an update.

It's the PE firms' job to provide strategic guidance to improve the overall profitability of the acquired company, and advising on the compensation structure of a CSO is an area worth exploring to better achieve that goal. All too often, portfolio company executives make the initial mistake of allowing CSO candidates (who are typically great negotiators) to dictate their own pay packages, and they forget to revise those packages as the company grows and evolves. That oversight can lead to a host of issues, from misaligned incentives to internal discord among others in the C-suite.

For PE companies looking to establish and implement thoughtful compensation strategies among their portfolio companies, we have found that answering the following questions generally yields the most favorable results:

1. **Is the portfolio company a startup or maturing?** During the startup phase, traditional commission plans are commonly used to encourage the CSO to drive new logos. However, the company should be cognizant of unanticipated mega-deals, which can result in what might appear to be unreasonable payments in the eyes of fellow executives. More mature companies will generally assign the CSO to the executive bonus plan along with her/his counterparts.

2. **What outlook or time horizon has the CSO been given to demonstrate results?** If the planned holding period is very short, a traditional commission plan may be more appropriate to keep the focus on short-term results. As the time horizon increases and longer-term thinking and strategy are required, it's naturally more appropriate to reflect these considerations by employing the executive plan instead.

3. **What is the job focus?** For younger portfolio companies, where a CSO's role is to get deals in the door without concern for the more tailored aspects of the job, a traditional sales commission plan makes sense. However, if the role is supposed to be focused on building a sales strategy and infrastructure to sustain the organization in the long term, then the executive plan is more common and appropriate. In addition, maturing companies should reexamine the CSO's competencies when that longer-term thinking is required, to ensure the CSO is still the right fit for this transitioned role.

4. **What is the envisioned career development for the CSO?** Some organizations plan for a narrower, top-line focus on sales alone. For other companies, a career path for the CSO means greater and broader responsibilities, including leading a P&L. The executive bonus plan provides a better solution for encouraging, reinforcing and rewarding those broader accountabilities.

5. **How great is the need for close collaboration among other executive team members?** The greater the need for frequent, highly collaborative interactions to ensure quick and cooperative decision making, the more likely an executive bonus plan will help strengthen these messages and requirements for the CSO.

6. **In what role was the CSO immediately preceding this one?** If the CSO candidate was previously in a role with broader responsibilities and was included in that organization's executive bonus plan, then she or he will likely be more comfortable with and amenable to continuing such an arrangement. By contrast, a candidate who has been in a role focused exclusively on individual selling and who was rewarded under a traditional commission plan likely will want and expect to continue under a similar arrangement, particularly if they perceive a much higher upside.

7. **What is the current competitive environment and level of demand for this CSO candidate?** Exclusive of all these other considerations, the bottom line is if the demand for a CSO is urgent and specific, there may be no other alternative but to accommodate his or her individual demands and preferences. Regardless, it is advisable to think beyond the current situation to possible future scenarios and how they will be addressed. Many times, an individual is hired with the expectation of a short-term tenure, after which a different individual will be needed to take the portfolio company to the next level of growth.

It's crucial for PE companies to consider these questions and guide their portfolio companies depending on the state of their development and their talent needs. Structuring a plan blindly and improperly, without examining how the strategy may need to change with time and circumstances, can hinder portfolio companies' sales effectiveness – and thus, the PE company's top and bottom lines.

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IT SEEMED LIKE A GOOD DEAL AT THE TIME

By Michael McSweeney, Senior Vice President, TriVista

In the pursuit of a major transaction, every dealmaker suffers from some form of tunnel vision.

Thoughts of potential opportunity fill that tunnel with the brightest light, while unknown risks lurk in the dark. Today's frothy M&A market adds additional complexity and risk as historically high multiples, accelerated diligence timelines and quick closings become the norm. The need to quickly validate operating margin stability and new product development processes, as well as achieve a level of comfort that the company can handle the next potential down cycle, is more critical than ever. It is imperative that deal teams ensure they are asking the right questions and determine if management teams are equipped with the right tools and processes to navigate the high-risk terrain.

Quality of Earnings reports created a minor revolution in the 1980s, giving dealmakers clear-eyed data to inform their decisions. These reports have now become a requirement for every leveraged deal, and outside professional services organizations do an outstanding job analyzing historical financial performance and identifying potential opportunities. Similar types of due diligence have spread to information technology, environmental impact and, increasingly, operations. Unfortunately, the last piece has remained tricky, as every company's operations are somewhat unique. As such, it is virtually impossible for a PE firm to have internal resources capable of evaluating every company's business processes when they may look at hundreds of deals per year with many different processes, technologies and global operational dynamics. The ever-changing regulatory environment compounds the traditional challenges associated with business evaluations. For example, if you are buying a food or beverage company today, you not only need to conduct an operational assessment, but you will need to focus on regulatory compliance as well as assess the impact of the FDA's impending Food Safety Modernization Act.

Traditionally, a retired CEO from the target industry with the insights necessary to assess the company's position within the marketplace would conduct operational due diligence reviews. They would walk the shop floor, sit in on management meetings, read offering memoranda and provide experience-based commentary on the company's prospects. But this was a "Father Knows Best" model, not a rigorous approach steeped in data analysis, process mapping, productivity analysis, manufacturing cycle time assessment and the many other critical elements required to evaluate core business operations in today's complex environment.

"IT SEEMED LIKE A GOOD DEAL AT THE TIME": ILLUSTRATIVE EXAMPLES

Recently, we helped one of our PE clients assess an industrial products company. It quickly became evident during the operational due diligence process that the company was struggling to achieve a reasonable Overall Equipment Effectiveness (OEE) level. In several industries, up time on high-cost capital equipment makes all the difference to a company's profit margin. A piece of critical equipment running at 85 percent OEE can help you make a lot of money. However, if that same machine only runs at 47 percent OEE, you are giving up critical capacity and margin dollars. Fortunately for our PE client, we were able to show how this particular company could economically improve its OEE from below 50 percent to greater than 70 percent within 12 months. Likewise, through the OEE improvement analysis, capital expenditures could be dramatically reduced in future years. This analysis allowed our client to bid confidently and secure the asset. While others thought it was a good deal, our client was able to uncover the business' true potential, resulting in a great deal.

The importance of Quality of Operations™ can also be seen with another one of our PE clients making a growth equity investment in a food company. The firm had already spent close to $1 million in transaction fees chasing

a deal that entailed both significant risk and substantial upside potential. However, our operational due diligence work uncovered enough questions about food safety and regulatory compliance that we urged the PE firm to extend the deal's closing date. The deal paused just in time for an FDA recall that forced the food company to empty store shelves of nearly 50 percent of its product nationwide. We were able to work with the company, the FDA and the PE firm to navigate the recall, fix broken internal processes and create an action plan for an improved food safety program that would dramatically improve compliance. As a result, the PE firm was able to negotiate a better deal and, in exchange for its patience, purchase a much better company. What seemed like a good deal initially could have easily turned ugly: Had the recall happened under a highly leveraged ownership structure, the results could have been catastrophic.

At the end of the day, no one can predict the future. Great firms will still make the occasional bad deal, but focusing on validating current operational processes, identifying operational risks and quantifying operational opportunities might make the difference between securing a good deal or a lemon – or even help turn a good deal into a great deal.

Mike McSweeney is senior vice president at TriVista, a boutique operations consulting firm providing Quality of Operations™ Due Diligence, Enterprise Excellence and Top Line Growth services to middle market private equity investors and their portfolio companies.

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COMPETITIVE TECHNOLOGY SECTOR HAS COMPANIES CONCERNED ABOUT M&A

By Aftab Jamil and Lee Duran

Technology has been impacted by the availability of private financing perhaps more than any other industry.

And as competition continues to swell, companies are increasingly concerned about whether they can complete the acquisitions needed to stay ahead of the curve, according to the newly released eighth annual ***BDO Technology RiskFactor Report***.

While the report's findings were derived from the annual shareholder reports of the 100 largest public technology companies in the U.S., they have broader implications for technology companies that are private-equity backed or are looking for financing to facilitate growth. And quite a few companies will fall into this category, thanks to robust merger and acquisition activity. In May 2015, FactSet, a financial data and software company, reported that the technology sector saw 519 deals over the previous three months, an 18 percent increase in the number of deals closed during the same time period in 2014.

Amid historically low interest rates and readily available access to credit, more technology companies are turning to acquisitions as part of their overall growth strategy. It comes as little surprise, then, that they are increasingly concerned about M&A risks, specifically those relating to the successful completion and integration of current or future transactions. Our report findings show that all but one of the 100 largest public technology companies in the U.S. mention risks related to "management of current and future M&A and divestitures," an increase from 94 percent in 2014 and 88 percent in 2013.

The pressure for acquisitions stems, in part, from heavy competitive pressure, which was a core concern for every company analyzed. "Opportunities abound in the tech industry, so much so that companies are fiercely competing with one another to develop and introduce innovative products at a rapid pace while maximizing efficiency," said **Aftab Jamil, partner and leader of the Technology and Life Sciences practice at BDO**. "More companies are turning to acquisitions as a critical element of their strategies to enhance their technology and product offerings, which brings other challenges to the forefront, such as managing the integration of acquired businesses, international growth, complying with new regulations and mitigating additional risks by maintaining appropriate internal controls."

These findings indicate a strong deal-making environment, with companies looking to stay ahead of the competition through M&A – which could have both positive and negative effects on PE firms. That is, while PE firms looking to make an exit may easily find interested buyers, firms looking at an attractive deal for a technology company may face fierce competition from strategic buyers.

To learn more about risks in the technology sector, read the full ***2015 BDO Technology RiskFactor Report*** here.

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MARK YOUR CALENDAR

The following is a list of upcoming conferences and seminars from the leading private equity associations and business bureaus:

SEPTEMBER

September 8
ACG September Luncheon
Embassy Suites Downtown Convention Center
Denver

September 14-16
SuperInvestor Africa 2015
The Westin
Cape Town

September 18
Italian Private Equity Conference
Palazzo Parigi Milano
Milan

September 27-30
Fundamentals of Investor Relations
Taj Boston Hotel
Boston

September 30
ACG Investment & Finance Cross-Networking Event
Daniels College of Business – School of Hotel, Restaurant & Tourism Management
Denver

OCTOBER

October 6-7
PE/VC Finance & Compliance Forum
W Hotel
San Francisco

October 6-7
ACG Los Angeles 2015 Business Conference
Beverly Hilton Hotel
Los Angeles

October 9
SEA Private Equity Conference
Grand Hyatt
Singapore

October 13-14
M&A East 2015
Pennsylvania Convention Center
Philadelphia

October 19-20
Midwest ACG Capital Connection
Navy Pier
Chicago

October 27
Private Equity in Emerging Markets – Financial Times and EMPEA
InterContinental Park Lane
London

NOVEMBER

November 6
Nordic Private Equity Conference
Hilton Copenhagen Airport Hotel
Copenhagen

November 8-11
SuperReturn Middle East 2015
Ritz-Carlton, Dubai International Financial Centre
Dubai

November 16-17
EuroGrowth 2015
Mövenpick Hotel Amsterdam City Centre
Amsterdam

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