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PERSPECTIVES
PODCAST

EPISODE 10: PREDICTIONS FOR THE MIDDLE MARKET IN 2019

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

INTRODUCTION

Todd: Hi. I'd like to welcome our listeners to another episode of BDO's Private Equity PErspectives Podcast. My name is Todd Kinney, and I'm the national relationship director for BDO's private equity practice, and I'm based in New York. I'm very excited to have two guests with me today—two firms that are great friends of BDO. First, Matt Bernstein joins us from Raymond James. Matt is a VP within their investment banking group, specifically focusing on recapitalization, and restructuring, and also private capital solutions. Matt advises clients on in- and out-of-court restructuring transactions, complex corporate carve-outs, and other special situation transactions and financing. Thanks for joining us, Matt.

Matt: Thanks, Todd. True pleasure to be here.

Todd: Second, I'm delighted to welcome to the program Adrian Whipple, who is VP of Operations at TZP Group here in New York. Adrian has worked on numerous private equity fund audits and portfolio company evaluations, as well as delivered consulting services to PE clients, including transaction services and working closely with integration and separation teams. Adrian, great to have you here today.

Adrian: Glad to be here, Todd. Thank you.

BACKGROUND QUESTIONS

Todd: Awesome. Well, let's jump into it. Matt, I'll throw this one out to you. Why don't you tell us a little bit about Raymond James and your role there?

Matt: Sure. Prior to Raymond James, I worked at FTI Consulting doing restructuring and corporate finance consulting for a little over five years after graduating from Cornell

TOPICS DISCUSSED INCLUDE:

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University. I've been at Raymond James for a little over four and a half years now, and as you pointed out, currently a vice president in investment banking working with the two products that you mentioned earlier. So, Raymond James, itself, is a global, full-service financial institution with $10+ billion of market cap dedicated to the middle market, providing investment banking, equity capital market, retail brokerage, asset management, and many other services to its clients. At Raymond James, my group is a product group within the larger investment bank. We advise on M&A both in and out of bankruptcy, corporate carve-out or special situation transactions and financing alternatives up and down the capital structure. And we've successfully advised clients on transactions involving more than $100 billion of liabilities.

Todd: Awesome. Thanks, Matt. Adrian, as the VP of Ops at TZP Group, I was hoping you could tell our listeners a little bit about TZP and your role there.

Adrian: Sure. TZP is a private equity investor in the lower, middle market, focused on North America. Currently, investing out of our third fund and capital raising for our second growth fund. Focus is on primarily first-time sponsor capital, entrepreneur-led businesses, with a heavy management equity role. And I mention that because it's a very important part of our thesis to have the founders and entrepreneurs of the business stay on and have some skin in the game. We focus on some specific verticals, including outsourced business services in IT, real estate-related, or real estate-adjacent investments. We look at media and technology, as well as consumer services and products. I focus on value creation. During the due diligence phase, we'll look for opportunities where we think we can add value beyond bringing capital to the table, and then structure a plan to execute on those initiatives. I focus on the first 100-day plans, and then as needed throughout the lifecycle of the investment.

RECAPITALIZATION & RESTRUCTURING

Todd: Excellent. Well, let's jump into our first topic and Matt, I'll throw this one to you. So, we're winding down the year and taking a look ahead at what 2019 has in store. Since your work focuses on recapitalization and restructuring, could you tell us about the trends you're seeing right now in the market in terms of restructuring and distressed M&A engagements? And I guess secondly, if you expect levels of activity to be the same in 2019?

Matt: Sure, of course. So first off, we're seeing an uptick generally in overall Chapter 11 filings, and where we are today, we're actually seeing more and more companies entering bankruptcy with less liquidity than previous years, and thus the Chapter 11 processes are happening more quickly. We're also seeing many deals that are either teed up with a stalking horse or a buyer that's in line of sight or have a prearranged or negotiated deal heading into bankruptcy. From a sector perspective, we'll continue to see increased activity in the retail sector from a restructuring perspective. The retail environment remains weak due to continued slowdown of customer foot traffic from the effect of Amazon and other online retailers—a topic that was covered in one of your previous podcasts, and I don't see that trend going away any time soon. We think that companies will hopefully receive a band-aid from retail sales over the holiday season, but I think that's a short-term fix. And we also believe that, long-term, there will be more fall-out in the retail sector that in turn will impact the supply chain as well.

Todd: Awesome. Appreciate the plug to a previous podcast.

Matt: Happy to do it.

VALUATION

Todd: Nice to know we have a guest and listener here with us. Adrian, let's move the next question to you. So, at TZP Group, you frequently work with due diligence and analysis of performance for owner- and entrepreneur-led businesses. Maybe you could tell us more about your outlook really for valuation and multiples in the year ahead. Bring out that crystal ball.

Adrian: OK [laughter]. Well, that's an interesting question and one that we're constantly asking ourselves as we go through the market. And though, depending on what stats you're looking at, I think our view might be limited or specific to the opportunities that we look at. So, it may seem counterintuitive, but the multiples in our verticals and in our space have been quite high in the last year to 18 months.

Todd: Right.

Adrian: So, given the landscape going forward, there's a lot of uncertainty when you look at the political environment and the regulatory environment, as well as capital allocation and performance. But our expectation and hope is that in the year to come, valuations can sort of normalize in our industries and be a little less optimistic.

MARKET LANDSCAPE

Todd: Appreciate that insight. Maybe we'll throw out the next topic to both of you. First, Matt, there's mounting evidence that we're heading for a market correction. Do you believe that's the case? And if so, what consumer staples and essential services will do well in a downturn? Matt?

Matt: I would say with respect to a market downturn, I want to caveat that I'm not an economist, so my comments should be taken with that in mind. But what I can say is that in the credit markets, we've definitely seen increased leverage levels over the past few years. Recently, we're seeing loosening of financial

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covenants and combined with ultimately rising rates, that next default cycle, per experts, is expected to occur in late 2019, or as early as 2020 when maturities start to climb. So furthermore, we're also seeing default rates picking up as the default rate increased to 1.9% in the past month from 1.5% one year prior. In fact, Edward Altman, the founder of the Z-Score, a method of predicting bankruptcies, also indicated recently that his data shows that there are similar levels today that there were in 2007 for average value of your issuer. So, pretty interesting stuff there. And then as Adrian pointed out, our domestic political climate as well as influences abroad are obviously key factors, but I won't dig too deep into that just here. Most of the distress we've been seeing recently has been either company- or industry-specific resulting from technological development, change of consumer preference or other micro factors, and I think this will continue to impact the economy. As I mentioned before, retail with the shifting consumer preferences, and then the auto sector being affected by some of the tariffs that have been recently implemented or technological disruptions. Ultimately, I think the short answer is that volatility from where I sit today shows no signs of abating, and I think over the coming months, volatility will continue to pick up. Then to not lose sight of your second question, I think that in general, consumer staples and the essential services are typically safe havens during this period of market volatility, so I'll expect that trend to kind of continue.

Todd: Lots of good input there. Adrian, care to weigh in on anything Matt didn't cover?

Adrian: Sure. No, I'm glad to hear Professor Altman and I are on a similar page, I studied under him at NYU Stern. I think, well, first of all, I mean, not to state the obvious, but we were headed for a correction and the question is around timing and magnitude. As private equity investors, we're a little a bit of a longer hold, so our focus is less on the correction itself as it is when is it going to happen and how should we be thinking about it in the context of our operations of our portfolio companies and of course, how we go into the market to acquire and exit.

TRADE & TARIFFS

Todd: Fantastic. I appreciate insight from both of you on that. Let's jump to the next the next topic. Data is certainly signaling that trade tensions are starting to bite into allocations in capital raising. I guess Adrian to you, do you think the trade tensions and tariffs will continue to impact middle-market deal flow over the next year or so?

Adrian: Our primary focus is in North America, so the way I view this is as there are increasing trade tensions in tariffs outside of, especially outside of the U.S., depending on which geography you're talking, allocations of capital could tend to lean toward North American funds. We're optimistic in that context. If I'm an asset manager and I allocate X% per year to say the UK, I might be reconsidering that number right now given the uncertainty and the same could apply to other geographies. So, in that context, I think we stand to somewhat benefit and the jury's out.

DIGITAL TRANSFORMATION

Todd: OK. Let's move to digital transformation. According to BDO's Digital Transformation Survey, more than one-third of financial services companies are developing a digital transformation strategy. Adrian, let me ask you this one as well. What's your outlook when it comes to digitalizing PE funds and their portcos? Do you think the PE industry is ahead of or behind the curve?

Adrian: So, where you stand depends upon where you sit. From my viewpoint, the lower middle market PE funds, I think, have been somewhat behind the curve to an extent but there's been increased demand for digitization especially in and around reporting and compliance issues. That's one piece of the house. The other piece of the house, would be data analytics when you think of digitization. And I don't know that we're behind the curve there, I think we're very much in front of the curve. I think on the portco side, it's really the same. It's a sink-or-swim proposition. In the context of being able to analyze your data on the portco performance and understand where you need to be in the future, there has to be a move in that direction.

Todd: Appreciate that insight, Adrian. One aspect, certainly, of digital transformation in the PE industry is data-driven investment. I guess two parts here. As we look to 2019, do you expect to see the application of data science and algorithms to drive investments? That's the first part. And second, do you see the use of programs to figure out how companies will perform down the road? For this one, I'd like to get both of your inputs. Adrian first and then we'll have Matt chime in with his thoughts.

Adrian: Sure. The data science and algorithm element of investing is certainly on the uptick. And prior to joining TZP, when I was more on the consulting side, I would see more and more of our clients require a certain amount of data science even to look at opportunities. So, when we approached the market currently we are always thinking about how we can use data science and how we can use technology to prove management assertions and assumptions. And then also give us other insights that may not be obvious by looking at the historical sort of due-diligence-type packages. You can elaborate on that, I'm sure, if you're interested.

Matt: Sure, happy to. I think similarly, the trend we're seeing in professional sports right now where many teams are using data analytics to make decisions such as where to shift their players for a certain batter or the money ball effect of what type of player to invest in. I agree with Adrian, I think it'll be a trend that we'll see over the next year, maybe a few years. But actually, haven't seen,

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from my perspective, a ton of funds doing it yet. What I would say is that these data science and algorithms would drive investments by highlighting metrics that actually impact a company's value. It'll kind of separate the trends from noise in the data and help the PE firm address them quickly in order to maximize profitability. I think, ultimately, this will just be another data point to develop evaluation and won't be fully relied upon similar to how there are multiple methods to value a company. Also with management fees under pressure, stakeholders want more transparency, so I think they'll need to benchmark and generate some sort of trend analysis and use this data to do so.

Todd: Good stuff. And now we'd like to take a quick coffee break with BDO's Alison Torres and Eric Fahr, who are partners in the Transaction Advisory Service practice in the Atlantic Region. Alison and Eric will share their expertise and insights.

COFFEE BREAK WITH ALISON TORRES AND ERIC FAHR OF BDO'S ATLANTIC REGION

Alison: Hi, everyone. This is Alison Torres. I'm here with Eric Farr. And we are very happy to have a few minutes to share our insights with you today. So, let's get right to it. From a valuation and market landscape perspective, what we in BDO's Transaction Advisory Services practice have seen has been dead-on with what Adrian mentioned. Multiples have been high for desirable assets and many of our clients as buyers have begun to express concerns over overpaying. That being noted, at this point, they are still buying. Looking forward, however, I think everyone agrees that some level of correction is on the horizon. But whether that happens in 2019 or 2020 and how meaningful it is is the answer everyone's looking for.

Eric: I'm actually fairly optimistic with the outlook for M&A transactions in 2019. Even with the house flipping in the midterm elections, many of the tailwinds behind M&A and economy overall are expected to continue. For example, although further tax cuts aren't likely, neither is the change to those that were already implemented. So, I'd expect a continued favorable impact to consumer spending. And deregulation is expected to continue as well as infrastructure spending, given bipartisan support. Offsetting some of these tailwinds is the continuation of rate increases from the Federal Reserve. However, although this will impact M&A to a certain extent, I don't think nominal increases in rates will have a noticeable impact on transaction volumes—at least not in 2019. What tends to impact M&A activity the most is uncertainty. And there is some uncertainty in the markets at the moment, especially internationally. For example, Brexit with the UK exiting the European Union is set to occur in March of '19. Although this could get pushed out, it appears imminent. And what happens in the European economy and a union that excludes the UK is a bit of a mystery still. Another area affecting international markets is ongoing trade wars and tariffs, which are causing some turbulence with cross-border deals. Alison, overall though, I'm expecting continued strong M&A activity into 2019.

Alison: Great points. So, I know Adrian and Matt are going to talk about the role family offices have been taking in M&A. I will say the biggest changes we've seen in our practice is that these family offices have brought additional resources in-house, which has allowed them to invest directly rather than just being private equity LPs. Over the past five years, our practice has been engaged by family offices on a number of engagements to perform due diligence and tax structuring services for potential direct investments.

Eric: I agree that family offices are another example of more Capital Chasing deals driving valuations higher. One other key difference in most family offices relates to holding periods. Although the family offices are acting more like private equity, they don't have the same constraints over holding period. Especially with lower and mid-market M&A transactions, family-owned businesses sometimes value a longer holding period, giving family offices a competitive advantage over traditional PE.

Alison: Well, Eric, it looks like, despite some concerns, things look good going into 2019. Thank you, everyone.

SPECIALIZATION

Todd: Thanks, Alison and Eric. And now, back to our conversation with Adrian and Matt. Let's move to specialization. I guess we'll go to Adrian on this one. We're hearing a lot about how specialization is key with increasingly more funds differentiating themselves with niche industry focus, with greater competition and firms jostling with LP commitments. Do you see that trend continuing in 2019, Adrian?

Adrian: I do, somewhat sadly, as I can refer to myself as a generalist [laughter]. But the reality is when we look back and get feedback from the market, there's a certain amount of efficiencies to be gained by specialization. A team that has been there and done that will be able to ramp up faster and get to the answer faster in a process. And then, I think, post-close we'll also be able to effectively manage the operations just with a little more finesse and skill without needing to leverage outside help, i.e. outside additional expenses. So, I think specialization is key going forward. That said, we still need to remain opportunistic to the extent that makes sense. As Matt points out in his answer related to data-driven investments, these will not always be the sole deciding factors. There are other elements that will take precedence such as relationship and fit.

Todd: Thanks. Matt, care to share any additional thoughts on the topic?

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Matt: Sure, I totally agree. As we've hit on a few times now, we're in such a competitive market right now. I think in order to not only gain LP commitments and ultimately source deals, specialization is key. I was actually talking to one of my colleagues from our financial sponsors group the other day, and he noted that many firms are focusing on niche strategies in order to put capital to work which obviously is difficult in such a competitive market. Those who say they're knowledgeable in the space may not have as much success deploying that capital as someone who's a true expert in that space. So, I think that's important. Then generally for the deals that we're marketing, I've come across large PE firms that have been expanding their business to include niche strategies and also firms that are solely focused on these sectors as well. Some PE funds have also spun off private debt arm debts, as well, to continue to diversify.

Adrian: Yeah, and just to add to that a little bit, one of the things that we've tried to do as we think about specialization, is we'll still address five to six verticals in the market and we'll just have our teams, almost silos, in specific verticals, right. So, it's not to say that a fund has to be specialized, right, so much as can we bring a team to the table who has that deep knowledge that you're referring to and can we get up to speed quickly.

Matt: Yeah, I totally agree. I've seen that.

FAMILY OFFICES

Todd: Nice. All right, well, certainly a lot of chatter in the industry about family offices, so maybe we can have a question on that topic. I would say the appetite of family offices for private equity has certainly led to more investment competition. You guys could tell me if I'm wrong, and the figure of average family office portfolio investment in private equity is expected to climb in 2019. I guess, Matt, why don't we go to you first and then Adrian. Do you work with a lot of family offices and have you seen their market could expand?

Matt: Todd, we actually do spend a lot of time with family offices. What I would say is that family offices manage more capital, are more sophisticated, and have greater expertise in-house than prior to the financial crisis, where historically they were paying money for external management advice and they've certainly evolved into this role. Just by way of background, in 2008, globally, there were 1,000 family offices, and today there are about 10,000, so major expansion there. What I would also say is that many family offices are able to aggregate funds that may just not be their own family money, but it may be a handful of family offices with like-minded individuals and investment principles coming together to invest in deals, as well. We also continue to see there's a significant amount that continues to be invested in private equity and debt transactions via family offices as these family offices are a nice alternative to some of the institutional money out there. And then finally, PE firms like TZP are becoming more and more familiar with these family offices. So, I've seen that they're willing to co-invest in deals as well. Based on all this information, we continue to see that family offices are active and meaningful participants in our processes and I think they'll continue to be as well going forward.

Todd: Good insight. Adrian, what are you seeing?

Adrian: Certainly, I've seen an uptake in the activity as Matt alludes to regarding family offices. They're much more prevalent in the market as direct investors and PE-style investments. But certainly, as you allude to; willing to partner up with family offices and make deals that make sense, I think that there is a growing appetite for targets to entertain that possibility. The only sort of downside or risk that I can see at this point is whether or not the family office has the sophistication and the Rolodex, if you will, to be able to bring more than the investment dollars, right, and that's where I think partnering with private equity funds like TZP could add a lot of value in those types of transactions.

Todd: Great. Well guys, we've come to the end of another podcast. Adrian Whipple of TZP Group, and Matt Bernstein with Raymond James, thanks so much for joining us today. I know our listeners will enjoy all the insight you shared, you're both very good friends of BDO and we appreciate the relationship with your firms. To our listeners, thanks so much for tuning in. If you haven't already, we'd love for you subscribe, rate, and leave a review of the show on iTunes. Until next time, have a great day.

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