BDO

PRIVATE EQUITY PERSPECTIVES PODCAST

EPISODE 6: DIVERSITY, ADD-ONS, AND THE CASE FOR CAUTIOUS OPTIMISM

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

Todd Kinney: Hi. This is Todd Kinney with BDO's Private Equity practice, and I'd like to welcome our listeners to another episode of Private Equity PErspectives. Today, I'm very lucky to have two of my favorite lady dealmakers in the middle-market PE ecosystem. I've got Gretchen Perkins with Huron Capital and Kathleen Lauster with Silver Leaf Partners. Ladies, thank you for being my guests today.

Kathleen Lauster: Thank you.

Gretchen Perkins: Thanks for inviting us.

Todd: Absolutely. Why don't we start with Gretchen? Maybe you could just tell us a little bit about your firm and what you do.

Gretchen: Sure. Thanks, Todd, and thanks BDO. I am with Huron Capital Partners. We are a lower middle-market private equity fund. We have two strategies: we invest on a control basis, and we also invest on non-control equity basis. We like businesses with revenues from $20 [million] to 200 million based in the U.S. and Canada, and we have three verticals in which we invest, those being consumer products and services, business services, and specialized industrials businesses. Kathleen?

Kathleen: Silver Leaf Partners is an institutional brokerage firm providing capital introduction, corporate advisory, and brokerage services to institutional clients. Personally, myself within Silver Leaf, I focus on lower middle-market private equity. I'm generally sector agnostic and tend to play in deals that are special situations, hard to place, and unique set of circumstances.

TOPICS DISCUSSED INCLUDE:

Read more ▸

OVERCOMING THE COMPETITION [1:54]

Todd: Got it. Well, both of your firms are great friends of BDO, and we're big fans of what you're doing out in the marketplace. I guess to kick it off, we all know PE firms have record amounts of dry powder and that is certainly easily accessible, but with that comes pretty fierce competition and valuations that are certainly frothy. So, Kathleen, I guess I'll start with you. The million-dollar question is, how can investors overcome the competition and, really, the high valuations to find a way to put their money to work?

Kathleen: Right. So there's more than just the dollar price on the deal and whether it's an auction or a more quietly marketed deal, I always tell my clients that we're not necessarily going to go with the highest bidder. We want to go with the most attractive bid. And so there's a lot of things that you can do as a buyer to make yourself more attractive and some of those areas that I would recommend focusing on is value added areas where you have strengths, synergies with existing companies that you may have.

For example, perhaps this is a food distributor and you as a buyer have a good experience in building brands and expanding those beyond where their current niches are. Other things that you can look at is structural concerns. So really look at what the seller's needs are. Do they want to—perhaps you enter initially in a non-controlled position with the idea of growing over time or there is—perhaps it's an outright sale but there is an opportunity for the seller to participate somewhat in the upside down the road.

And then, finally, this is very much a relationship-driven business. And so there's just no shortcuts in terms of developing reputation in the market and making sure that you're visible. Particularly with family offices, I find that you have to balance the need for secrecy and privacy with not being so hidden that nobody can find you because if you're only seeing a handful of deals a year, then you're not going to be investing in the best opportunities.

Todd: Yeah. Good points. Good points. So I guess, Gretchen, same thing. How's Huron getting deals done?

Gretchen: Yeah, this is a challenging market indeed with valuations being so high right now. We employ multiple strategies. We actively court and market to independent sponsors for proprietary deals that they sign up and we like to back independent sponsors, those are good strategies for us.

We create our own proprietary deal flow through a strategy we call our Exec Factor Program. And these are scenarios where we back executives who have multiple years of experience in a particular industry and now want to go out on their own and acquire smaller businesses, lower middle-market companies, in their area of expertise, and we partner with them. And we are committed to them, they are committed to us, and we go forth on a strategy to find companies to invest in.

And we are a better buyer because we have a rock star executive in a certain space to help us get to the companies we want to get to. And the executive is a better buyer because they are backed by a firm with our capabilities and our track record and our capital. So we call those Exec Factors, and we have numerous those in our portfolio right now.

Might take 12 months, it might take 24 months for us to find that first platform company in which to invest in partnership with the executive. And after that, it's typically off to the races in terms of generating add-on deal flow for that platform.

And then we also market very broadly to all of the other sources of deals in our ecosystem. The accounting firms, the law firms, the wealth managers, the boutique brokers and investment bankers.

And through all of those strategies, we're able to generate, to your point Kathleen, a really large number of deals coming into the funnel at the top so we don't ever have to get too picky and we can really focus on the deals where bringing our resources, our operating resources and our operating partners as well as our experience, helps us get the deals done in this market.

ADD-ONS AS A GROWTH STRATEGY [6:27]

Todd: Well, I think being creative and thorough is the motto there. You touched on add-ons, maybe we'll turn to that topic. Certainly, I think according to PitchBook, nearly 30 percent of PE-backed companies now undertake at least one add-on acquisition and that's up from, I think it was about 20 percent in the early 2000s. So I'll throw this one out to both of you, maybe Gretchen first. Huron has obviously announced a few add-ons recently, why do you think add-ons have become so popular in the middle market?

Gretchen: Yeah, add-ons have been a real engine of growth for us and frankly, it's tough to achieve organic growth in a low GDP environment. Certainly, we're making growth—we're accomplishing growth through bringing our operating resources, but one of the key principles that we have for shareholder value creation is doing multiple add-on acquisitions. So that's a key focus for us, and again, it's an ability for us to generate higher-than-market growth rates. Because, as I said, it's a challenge to do so just organically based on this economic environment.

Todd: Sure. I guess Kathleen, same topic. Has the Silver Leaf team noticed an uptick in PE add-ons? And I guess the second part is, are there any specific industries where you're seeing this occur more often?

Read more ▶

Kathleen: No doubt about it, platform companies are kind of the new buzzword, I would say. And why is this the case? Well, kind of going back to your previous question, it's an opportunity for acquirers to realize synergies with their existing holdings. And so, therefore, allow them to be a little more competitive in an acquisition process.

With regards to the types of industries that I'm seeing this play out most commonly, it's the ones that are certainly more fragmented right at the moment. Often more old school, traditional industries where you've got a lot of family-run businesses, scenarios where there wasn't a lot of vertical integration historically. And perhaps it's a sector where it just doesn't hold a lot of interest to the younger generation.

A couple that come to mind, I mean, I've seen the shipping sector. I worked on a deal recently along those lines. I've seen family-run dealerships. I've seen a lot of consolidation in that space because, again, it's just a—you've got the young generation that's running to Silicon Valley, and so there's no transition plan. And so that's a great opportunity to pick up some platform companies.

TAX REFORM'S IMPACT ON PRIVATE EQUITY [9:23]

Todd: Okay. All good points. Thank you. Gretchen, I'm going to put you on the hot seat here with respect to tax reform. I think it's a topic we've broached in every podcast we've had so far, and it's always good to get our clients' perspective. Are you really seeing any scenarios where tax reform provisions are impacting deal activity or valuations for that matter?

Gretchen: Yeah, couple of areas. I mean, first of all, I think many of us, in our world, were quite surprised that they really dropped the corporate tax rate to 21 percent for most companies. Sorry for you accounting firms and law firms who were specifically written out of the code. But for the most part, businesses in the U.S. now have a much lower corporate tax rate, and that was a pleasant surprise.

In terms of what impact it's having on valuations and deal activity, I mean, companies have more cash flow now, so their valuations are higher. The market is robust. As we said, challenging if you're a buyer; robust if you're a seller. Robust if you're a service provider. There's lots of deals getting done. So I think that has definitely been a positive impact on valuations.

Another big part of—another result—we thought it could be much bigger, but it really wasn't that limiting, was a limitation on the interest expense deductibility to 30 percent of your EBITDA. That is a minimal impact in our world and our ecosystem in lower middle-market buyouts. Most of us don't leverage things to the extent that your interest expense would ever comprise 30 percent of your EBITDA. So that has not been a limitation.

But I think this could very well be one of those things that when the downturn comes, whenever that is, there is an unintended consequence of this new provision that once you have companies starting to lose money or profits are dropping, EBITDA is declining, and your interest expense, by definition if you're in a downturn, is probably going up, there's going to be instances where the tax provision, this tax change, has accelerated the decline of a struggling business. Because at some point, in these troubled businesses, the 30 percent limitation will be breached and then that just reduces their cash flow even more. So I'm quite sure that was not intended, but we all need to be on a watch for that when the downturn comes. But otherwise, I think tax reform has been a positive influence on deal activity.

KAREN BAUM TALKS PE TRENDS AND ESG [12:21]

Todd: Our discussion with Gretchen and Kathleen will continue after we take a quick break with BDO's own Karen Baum. Karen is a national partner in BDO's transaction advisory services practice where she acts as an M&A advisor.

Karen: Hi. My name is Karen Baum and I'm a national partner in BDO's transaction advisory services practice, and I've spent more than 25 years working in the transaction space as an M&A advisor, an entrepreneur, and as an operator in a number of PE-backed companies. And today, I'd like to talk to you about two trends that I thought you might find interesting. So, the first trend that we're seeing is that sell-side due diligence is becoming more and more popular here in the U.S. And it's becoming increasingly important as well in the current deal environment, and I'd like to kind of walk through that. So, I think that all of this makes sense when you look at the current market context, and there are certainly no surprises here. In fact, if you take a look at PitchBook's latest results, median valuations for deals in the U.S. are continuing to hold at an all-time high. Still averaging at over 10 times the EBITDA so far this year. And it's still very attractive for sellers of all kinds to continue to get into the market.

Along the same lines, we've also seen an uptick in sell-side due diligence activity. And that's not just because there's so much more market activity going on right now, but we're really seeing that more sellers are recognizing the benefits of undertaking diligence and are engaging in the process. And, in fact, if it's done well in advance of the transaction or a sale process, not only does it help avoid surprises that might crop up during the course of a deal, but it really does allow the seller to address issues that typically can help preserve or even enhance the company's value if they're addressed early on in the process. In addition,

Read more ▶

I'd like to mention that we've had a number of situations where we've identified add backs in the Q of E process, that the seller was unaware of, that had a significant impact on the pricing of the deal. And in some cases, gave the seller a much stronger negotiating position. So these are all really good reasons at why you'd want to consider doing sell-side diligence.

Some of the other benefits we've seen as well include a much shorter sale cycle, and a much more efficient transaction. In fact, the sell side process really helps avoid the deal from going sideways as a result of unanticipated problems and issues. Not to mention of course, the amount of time and energy that you have to spend to negotiate through the various issues that crop up. And certainly, if you had dealt with them earlier on, it would collapse the timing of the sale process itself. On top of that, I think it's important to point out that in the current deal environment with such high valuations and often even higher expectations on the side of buyers, sellers really need to be very well prepared to articulate their vision, their story, but also their financial position, their operations, the taxes. Really the whole operations or activity of the company, really soup to nuts, in order to establish and earn the buyer's confidence not only in the company, but in management as well. So pretty much like anything else, proper planning and preparation can be one of the most important ingredients, I think, to maximizing the value and ultimately the success of the transaction. And the best part of all this, is that the benefits of sell-side diligence far outweigh its cost.

The second trend is one that I've personally been interested in for some time now, and that's the growth or popularity of what's referred to as SRI, which is Socially Responsible Investing. Sometimes you'll also see this referred to as ESG, which is Environmental, Social, and Governance investing. And so, I first became interested in SRI a few years ago when I read a book called Megatrends 2010: The Rise of Conscious Capitalism. And the book was written of course, with the benefit of 20/20 hindsight after the whole Enron debacle back in 2001. They're really sending a message, I think, loud and clear about social responsibility, about ethics, and corporate governance. And the lack thereof can certainly have devastating impacts on corporate reputation and profits.

In turn, modern day social responsibility investing eventually evolved out of the political climate of the 1960s, where investors who had social concerns really sought to address issues around things like civil rights, labor issues, and equality for women, amongst other issues. And today, we see socially responsible investing as a growing market in the U.S. and across Europe. And its become a very important principle in driving investment strategies for a number of funds and investment vehicles.

One of the newer trends in SRI is referred to as positive investing, and this involves investing in companies that are considered sustainable. And that's not just in terms of environmental or in a humanitarian sense, but really in terms of a company's long-term potential to compete and succeed. And so far, the returns have been very good. In fact, according to a recent Morgan Stanley study where they reviewed 10,000 investments and they determined that strong sustainability investments consistently outperformed weak ones, which seems to make a lot of sense.

Another interesting trend that's emerged is impact investing, which is the alternative or the private equity version of positive investing. As you can tell, different types of investors invest differently in social investing. And so here we see more private equity and debt investments that are made in businesses that provide some sort of social or environmental impact. And it's interesting to note that this kind of investing actually started in the VC community where investors frequently took an active role in mentoring the founders and helping to lead the growth of these companies. So just going back to the private equity perspective on this, yeah, I think it's important to note that social investing programs are an awful lot more than just a feel-good marketing strategy to go out and raise funds. They really do provide a great opportunity to bring about positive change. And in fact, I think it was last year TPG raised two billion in its global impact fund which was actually oversubscribed. And since then, they've invested in companies that do a variety of things, including improving learning outcomes for underserved communities. They provide digital education. They reduce barriers to entry for unbanked and underbanked consumers, just to name a few. So, there's a lot of different types of funds and types of community outreach that these funds are providing capital for.

I should also mention that institutional investors have been very active in this space and have showed an increased interest in investing in PE funds that have a social responsibility investment mandate. Certain mandates now include exclusion of funds or companies or activities or even industries that are deemed unacceptable or controversial. And I think it'll be very interesting to see how social investment strategies continue to evolve and whether investors interested in this area will actually stand the test of time. But I think if history is any guide here and given the latest wave of issues around corporate governance and ethics that we see in the news virtually every single day, I would venture to say that social responsibility investing is here to stay. And as Warren Buffett once said, it takes 20 years to build a reputation and five minutes to ruin it. And if you think about that, you'll do things differently.

Todd: And now back to our conversation with Gretchen Perkins and Kathleen Lauster.

Read more ▶

PREPARING FOR A DOWNTURN [20:49]

Todd: Excellent. In most of our podcasts, we ask our guests to kind of pull out their crystal ball and give me your outlook. Let's focus on near-term for kind of PE deal activity and valuations. What are you thinking?

Kathleen: So the funny thing is—I laugh because I feel like for the last 18 months I've been hearing everyone say that the downturn is about 18 months out. So here we are and it doesn't look like it's imminent.

There's no question we're in a situation now where, as we discussed, valuations are very high and at the same time there's a lot of dry powder out there and a lot of pressure to get deals done because there's the potential that if committed capital isn't being used it's going to be lost by fund managers. And then there's just the sentiment that as long as the music is playing you have to be at the dance.

And that being said, we are in the second largest expansionary period in U.S. history, and I would say the market at this point is expecting [inaudible] August. Don't think we have too much farther to go. There's no question we're closer to the end than we are at the beginning. It's very hard to pick a market top or bottom. And at the end, there's going to be a catalyst that changes everyone's sentiment. And is it going to be geopolitical? Is it going to be something closer to home? Policy-driven? Remains to be seen.

I think that valuations are going to remain strong through the remainder of this year at least. And what I advise sellers is that if you think that you might be looking to exit in the next five years, now is the time to really start taking that seriously and taking action. And on the buyer side, just be cautious and try to, if you can, retain some dry powder for when the inevitable downturn takes place because then you'll be in a great position to acquire assets.

Todd: Yeah. Good point. Good point. Gretchen, you must have some perspectives.

Gretchen: Yes. As I said, I think tax reform has extended our bull market and things are looking rosy for the near term. All the economic indicators are strong. But at some point, interest rates will rise and the current tight labor markets at some point are going to result in higher wages.

And costs increasing for businesses will ultimately, at some point, start putting the brakes on. I completely agree with Kathleen. There will be some catalyst, some exogenous, or not, event that will step on the brake firmly. And when the banks start pulling back, that's the beginning of the chilling of the market. That's always the thing that begins the market slowing down. And I don't know when that will be, but I would say we're somewhere in the seventh inning, ninth inning of this expansion. I don't know, but clearly, we're at the back end.

And banks are very liquid right now. Banks and non-banks. All sorts of debt financing are plentiful. Lots of competition when we're going to market to finance our opportunities. And when that starts to pull back, that's when things will decline or slow.

Todd: Interesting. Well, I'm going to make a note on my calendar to go back and listen to this podcast in a couple quarters and see who was right.

Kathleen: Yes. See who was prescient or not.

WOMEN TO THE TOP [24:45]

Todd: Well, I would, I've got one more topic and it's diversity. I would be embarrassed if we didn't broach the topic. I'm lucky enough to have both of you here today. We've got PE and investment banking represented.

So, I guess I saw a recent stat, that Preqin released some data saying that women make up only about 18 percent of PE employees and I think that number in and of itself may be debatable. But both of you are certainly highly accomplished professionals. Perhaps you can give our listeners some insight into the secret of your success, and really, do you have advice for other women seeking to follow your footsteps? Maybe, Gretchen, you want to start with this one?

Gretchen: Sure. I'm glad to see that number by Preqin is 18 percent, I anecdotally feel it's 10 percent, it was 10 percent when I started in this industry 30 years ago. Feels like 10 percent now when I go into large meetings or conferences, still feels like 10 percent, and I think there's a couple reasons for that.

One is, young women today coming out of top programs, top schools, they have a lot more choices today. I think that's one of the reasons our industry has not moved the needle on increasing women representation. I think there's a lot of other opportunities, they can go into many other fields, there's so many more young gunners graduating from top programs who are starting their own companies and they're going the entrepreneurial route. And that's great.

For our industry in particular, I think there's a lot of challenges in our industry. It's a very rigorous place to do work, the deal environment has a lot of pressures and a lot of travel, and I think part of it is a lifestyle choice. You either choose to be in this very vibrant environment working with really smart people and really hard-charging executives at companies that you're looking at to invest in, and it's fun and it's invigorating, but the downside is it's a lot of hours and it's a lot of travel.

Read more ▶

So I think part of it is a lifestyle choice, and we need to do a better job as an industry of embracing women and asking them and imploring them to just hang in, because there's a heavy bailout rate after a young woman starts a family, for instance. Because there's multiple pressures and it's tough.

But I think advice I would give to young women is, high achievers in this industry can get pretty much all the flexibility they want. But you have to be good, you have to be operating at a high level. Folks who—I always tell young women, I've advised numerous young women over the years, maybe they're expecting and asking for advice because they know I have millennials and I've somehow made it and my kids are great, you know, "How do you balance all this, Gretchen?" and I always say, "Just, you be unapologetic. When you've got to walk out of that office at 6 o'clock because you've got to relieve the nanny or pick up the child from daycare, just be unapologetic, walk out, and get back on your computer at night.

It's okay if you're walking out and all the guys are still sitting at their cubes. Because they're going to leave and their night's going to be done at some point, probably soon after you, frankly. But everybody's going to work hard. And if you work hard and if you're a high achiever, that is not going to be an issue at all. Where it's a problem is when someone expects that sort of accommodation and then doesn't kill it, frankly, so."

Todd: That's awesome. Thanks for your candid thoughts. I think that's very helpful. Kathleen, what are you thinking?

Kathleen: Yeah. So I also question that 18 percent statistic and the only way I could perhaps reconcile that is that, at the junior levels, I think that there has been a lot more evening out of the ranks. And if you look at analysts or etc., it may even be closer to 50/50 or somewhere approaching that. Unfortunately, and sadly for young women, it's more at the senior levels and they don't have a lot of mentors to look up to because at the senior levels and where Gretchen and I are at meetings, it's certainly 10 percent if that, you know?

So it's unfortunate because it does kind of become self-perpetuating.

The advice that I would give, that I always give and particularly for women is, first of all, just to be persistent and don't be afraid to make mistakes. Everyone does. I mean, when I was younger, I was much more self-conscious about that. And now I realize that the mistakes I make are my opportunity to learn and I've made a few. Don't get me wrong.

And along the same lines, don't let setbacks destroy you. I just think that women tend to internalize their mistakes a bit more than men. It's just the way we are and you got to brush yourself off and get back in the game.

And then, finally, the other piece of advice I would give—and this goes for both men and women who want to work on Wall Street and stay relevant in financial services—is that you really need to be flexible. It's great to be a specialist but whatever you're specializing in, that'll eventually go out of favor. And if you can't pivot and if you can't find a way to take the skills you've learned there and focus on something a little bit different, then you will ultimately become irrelevant. And so constantly learning—constantly growing and learning and seeking what the next opportunity will be.

Gretchen: I completely agree with Kathleen. That ability to have a broad range view is essential and you don't realize that until you're further on in your career, right?

You're a couple decades in. You realize that those with the more broad experience are more sought after. The only other thing I'd throw in there is it's business. It's not personal. So when you have a setback or when you make a mistake, exactly what you said, shrug it off. It's business. It's not personal. It's not about you. It's just about what you do at work.

Todd: Listen. I've got two teenage boys and there's a lot of stuff that you guys just shared that's just frankly awesome and I'll be debriefing them. So thanks. Thanks so much for those life lessons.

Well, that's going to wrap the podcast for today. So Gretchen with Huron Capital, Kathleen with Silver Leaf Partners, can't thank you enough from the BDO family. We're very appreciative of your time and effort to prep for the call and join me today. And strongly encourage our listeners to go out and learn more about Huron and Silver Leaf and do business with these firms like BDO is doing. We're huge fans of them and thank you very much.

Read more ▶

For more information on how BDO supports private equity sponsors, funds, and their portfolio companies with a full spectrum of accounting, tax, and advisory services, please visit us at BDO.com.

If you enjoyed the show, please visit iTunes to subscribe, rate, and leave a review. Join us next time for another edition of Private Equity PErspectives, and listen to the full series here.

CONTACT:

SCOTT HENDON
Private Equity Practice Leader
214-665-0750 / shendon@bdo.com

TODD KINNEY
Director, Private Equity Industry
212-885-7485 / tkinney@bdo.com

People who know Private Equity, know BDO.