PRIVATE EQUITY
PERSPECTIVES
PODCAST

EPISODE 11:
TRENDS & TAKEAWAYS FROM BDO'S 2019 PRIVATE EQUITY PERSPECTIVE SURVEY

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

INTRODUCTION

Todd: Hi listeners. I'd like to welcome you to another episode of BDO's Private Equity PErspectives Podcast. I'm Todd Kinney, the National Relationship Director for BDO's Private Equity Practice. I'm excited to have two guests with me today. First, David Glazer joins us from Gladstone Investment. David is a Director focusing on acquiring mature, lower middle-market companies with attractive fundamentals and strong management teams. Great to have you to the podcast, David.

David: Thanks, Todd, appreciate that.

Todd: Second, I'd like to welcome to the program, Jon Tenan who's a Director at Lazard Middle Market. Jon's a member of the Consumer, Food & Retail Group where he advises both public and private companies in the consumer retail industry on a variety of strategic alternatives, including M&A, restructurings, and debt and equity financings. You sound like a busy man, Jon. It's good to have you with us.

Jon: Thanks for having me.

BACKGROUND QUESTIONS

Todd: David, let's start with you. Maybe you can kick things off by telling us a little bit about Gladstone and your role there.

David: Sure, absolutely. Appreciate you having me join you here today. So, for quick background: Gladstone Investment, we're a publicly traded, buyout fund based in McLean, Virginia, right outside DC. We're traded on the Nasdaq under the ticker Gain G-A-I-N, and we essentially, we invest in lower, middle-market companies. Anywhere from $3 million to $20 million of EBITDA, and we're typically the primary equity investor in any acquisition.

TOPICS DISCUSSED INCLUDE:

In addition, though, other than being publicly traded, we differ from a traditional private equity firm, in that we also provide the debt alongside all of our equity investments, and we never make one without the other. Obviously, providing most, if not all, the capital structure in any type of transaction. We believe that brings certainty to close and a level of simplicity to it as well. In terms of what we're focused on, we're truly industry agnostic, I'd say, but historically we have had a focus on consumer products, business services and niche manufacturing. In terms of my role, my colleagues and I are all really involved in both origination and new opportunities. So, making sure guys like Jon are thinking of us on new opportunities, as well as a role in portfolio management, where we're really all involved from a board level to help our companies think strategically about the next stage of growth.

Todd: All right. So, you're doing it all. Perfect guest. Jon, as a Director at Lazard, hoping you can bring our listeners up to speed on your company and your role there.

Jon: Sure, thanks. So, the Consumer, Food & Retail team at Lazard Middle Market sits in a few offices across the country. We've got Chicago, Minneapolis and New York. I, myself, sit in the New York office and focus mostly on the consumer and retail side of that group, although we do work with the food team as well. We work with both founders and private equity funds, so we keep thinking of you, David, as well [laughter]. And I'd say, not exact percentages but 50/50 or so with entrepreneurs or private sponsor-owned businesses, which I think maybe we'll talk a bit more about later. In size range that we advise on, we broad stroke say $100 to 500 million in enterprise value, but that can flex up and down depending on circumstance and who it is we're working with. We're seeing some cool things in the market right now. I think it's an exciting time with changing consumer behaviors and how that's impacting the companies we're seeing.

INDUSTRY OUTLOOK – CONSUMER AND RETAIL SECTORS

Todd: All right. Well, glad to have both of you here. Let's jump in with some industry outlook stuff. So, David, I'll kick the first question to you. Two parts - in your opinion, can you tell me kind of what's driving interest and growth right now in manufacturing business services and consumer products, your sectors? And also, which of the sectors where Gladstone is especially active?

David: Yeah, absolutely. I mean, as is the case with the economy, in general, we've certainly seen some nice growth over the last several years across these sectors. Given Jon's background in consumer retail, I'll let him expand further on that topic. But, certainly, what I can add is it's the case within both our existing consumer portfolio as well as the new opportunities that we see that the most successful companies have really been the ones that have found a way to optimize their Amazon strategy without sacrificing pricing and margins in order to generate higher volumes. Obviously, we've seen that that comes with a benefit of being able to maintain your brand strength as well as keeping your brick and mortar guys happy, right? Because shoppers are now seeing the same price on and offline. In terms of other sectors, particularly what we call business services, we're definitely seeing some nice out-sized growth for those companies that are really benefitting from the rise in commercial real estate, even within niche categories. So, for instance, the rise of new build family entertainment centers in the U.S. and globally, that's been a huge support and help to our bowling products business, Brunswick. And then, within manufacturing, I'd say that the companies that are really generating the most interest and success, to your question, are really those that are truly diversified in terms of their customer and markets, with no real concentrations across some difficult areas. Oil, auto, areas that are particularly subject to more aggressive swings in a difficult economy.

Todd: All right. Good insight. Jon, I'll kick this one to you. Perhaps you could highlight some trends around changing consumer behavior and how that's affecting the retail industry.

Jon: Yeah. So, David was touching on Amazon, and I think that's been critical in shaping consumer behavior. If you look at online growth in totality, it's been phenomenal over the last decade. But if you take that apart and take Amazon out of it, it's a different story. I think Amazon is a huge factor in driving e-commerce and online growth. And so, a big change we've seen is five years ago, to use a round number, people were trying to stay away from Amazon as much as they could. When I say people, I mean businesses, not consumers. So, when we worked with direct-to-consumer businesses selling products, whether it was marketplace or consumer product companies, there was a specific strategy around trying to differentiate and stay off of Amazon with fear that Amazon would take over their business. Today, it's different. Today the strategy has shifted towards how do you coexist with Amazon? Whether that means entirely selling through Amazon, Wayfair, or the like, or having a strategy that's something like 50/50. We advised a business last year where the sales were roughly half and half through marketplaces and through their own website, and that's become a critical piece of direct-to-consumer businesses today.

PREPARING FOR A MARKET CORRECTION

Todd: Good stuff. Good stuff. Well, let's jump into the next topic, and the next few questions will refer to data and stats from BDO's Annual Private Equity PErspective Survey. Certainly a mouthful so in future questions, I will just refer to the survey, but remember that it's the Annual PE PErspective

Survey. So, the first stat is, according to the findings from this year's survey, 89 percent of PE fund managers expect a prolonged downturn sometime in the next two years. David, do you think the PE industry is starting to take steps to prepare for a market correction in the next couple of months or couple of years? What are you thinking?

David: Yeah, I think of them being fair. We're probably certainly within that 89 percent of funds that had a real concern about the economy over the next few years, just given how hot it's been. But at the same time, I think that even during these last few years, really positive times, we try to stay disciplined about our new investments. The reality is, is that we've lost out on a lot of opportunities that I know we would have loved to invest in and add to the portfolio. But at the same time, we simply didn't believe in a lot of cases that the multiples being applied to these companies was appropriate for the longer term. So, to answer your question, I guess, yes, perhaps we're even more cautious now than we have been. But I think most funds that are going to be successful over the longer term have done their best really for a while now to identify and avoid the natural exposures that are out there. Things like customer and supplier concentrations and market volatility. All of which obviously can have a punitive effect in a tough economy.

HEIGHTENED COMPETITION AT A TIME OF SEISMIC SHIFTS

Todd: Sure. Well, Jon, maybe we'll talk about competition, certainly as we know competition is fierce for new deals in the middle market. Eighty-three percent of BDO's survey respondents said most of the competition for middle market deals over the next year or so will come from PE firms followed by just 11 percent who said strategics. So, while strategic buyers continue to bid up prices, I think it's pretty clear that middle market PE peers are multiplying and at the same time we're starting to see some bulge bracket PE firms moving downward. So again, Jon, throwing this one to you, is any of this data surprising?

Jon: No, it makes a lot of sense to me. I think when we are strategizing at the outset of process, we always love to find the best strategic buyer at the beginning, right? We say to our clients, here are the guys who it would just make a ton of sense for them to fold you in to their business and here's why-- here's the synergy analysis showing why they can pay more. Now that said, we also typically preface it with, if you were to give me the field of sponsors versus strategics, we're going to take the field. Not only are we seeing more dry powder and more funds competing in the spaces they're in, but these guys are - like David- are proficient in executing upon these transactions. So not only do you have a much broader and wider universe that is growing, you also have deal teams that can get these things done quickly and efficiently. And so, we end up with clients who say, okay, not only are there less guys who are going to make sense here, but I want this thing done quickly and so you end up in a ton of situations that completely substantiate this data.

Todd: Good stuff. Makes a lot of sense. Well, at this point, we'd like to take a quick coffee break with BDO's Russell Clarkson and Shaun Buckley in the Southwest Region. Shaun is a Partner in the Transaction Advisory Services Practice, and Russell is a Managing Partner in the Technology and Business Transformation Services Practice. Let's hear their insights.

COFFEE BREAK WITH RUSSELL CLARKSON AND SHAUN BUCKLEY OF BDO'S SOUTHWEST REGION

Shaun: This is Shaun Buckley, Partner in the Transaction Advisory Services Group at BDO in Dallas.

Russell: And this is Russell Clarkson. I'm a Managing Director in the Management and Technology Advisory Services Group also in Dallas.

Shaun: We're here today to talk about some trends that were noted in BDO's 10th Annual Private Equity PErspective Survey. A couple things, Russell, that came up. One is digitalization. Private equity firms are pushing the portcos to digitalization, trying to gain some efficiencies, improve their return on equity or return on investment. Some of this is kind of a sector by sector thing. Healthcare, as we know, was mandated several years ago by the federal government to get into digitalization, electronic health records, that sort of thing. This is kind of your area. What are you seeing in digitalization out there?

Russell: It's a great question. I think it came out of the survey that PE firms are really looking at the digital potential of their investments. And one of the things that caught me is they're less concerned about the current level of digital maturity and more so are the companies that they're looking at, do they have potential. Is there something they can do? And healthcare's a gray area. I had the chance to work with a PE firm that was able to acquire a firm that basically focused on analytics to improve claims processing and flow through. So, if you're a doctor, claims are your cash flow. And if your claims are getting rejected, having to be resubmitted, or sometimes falling out altogether, that's a big impact. So, this firm had built a good model and they didn't have the investment they needed to be able to expand beyond just the local market. So, partnering with a PE firm or the investment of a PE firm allowed them to really be able to expand their scope. That was a great example of being able to take their analytics and be able to really expand both geographically and into new areas.

Additionally, even firms in the financial services market, there was a private equity firm that created a platform solution around mortgage brokerage helping mortgage brokers more successfully identify high-quality candidates. And once those candidates are identified, moving them through the process quickly to be able to get the close rate up and be able to generate more business than they were able to previously. So, it was more than just the analytics. It was also helping the whole customer experience get better. And I think that's what's important. So, when you think about digitalization, private equity firms as they look into their new transaction need to think about, as they're doing their due diligence, how does IT factor into that. Is the current firm digitally focused on that potential? You need to look at automation as more than just cost takeout. Are there ways to remove friction from the customer experience to make it easier to do business with your firms so you will be able to allow customers to have a better experience and make them come back, buy more, expand, etc. And we never can lose sight of the fact that many of these portcos sit on huge quantities of data. The best PE firms I think are asking, "How can we unlock and monetize that data?" It's not what we're going to do with the data, it's how can we use the data. And I think you'll see in the future going forward healthcare, financial services and many of the e-commerce firms generate huge quantities of data and offer new revenues.

Shaun: Russell, taking off on that, one of the other areas addressed in the survey was what the industry outlook for the Southwest Region is for 2019. We continue in the M&A world to see a very high level of M&A activity in healthcare and technology. There's certain sectors like in healthcare, such as dental and dermatology that are driving a lot of the M&A activity. Technology deals have been driven basically by SaaS, software as a service. Private equity likes those subsectors because they're steady cash flows. On the other hand, a certain sector such as retail and real estate, especially retail with brick and mortar is out, right? Everything is online. What are you seeing in terms of online projects in digitalization? What do you see in those sectors?

Russell: I think what's happening is a lot of the smaller firms get to a point where they become cash-constrained. So, a lot of their customer experience is built very traditional shopping cart-oriented where you log in to do something and you leave. Now, what you're finding a lot of the more advanced firms are doing are beginning to create an online experience that engages the customer to bring them back for more than just shopping but for information, for consultative services, for other areas that get them moving into new market and revenue streams through the online presence. If you think of it, 20, 30 years ago, everything started with a salesperson. Today, by the time you touch the salesperson, you might be already halfway through the transaction cycle. One sector in the Southwest is oil and gas. And oil and gas was depressed for several years because the commodity pricing was so low there was decreased activity in oil and gas in '18 until Q4. And in Q4 of 2018, the commodity price of oil fell dramatically. So, people are on the sidelines again really looking. And, of course, private equity firms kind of shy away from those cyclical industries. They're dependent on commodity pricing because that can be affected by a number of different variables.

Shaun: One other important area that came out of that survey was 89 percent of the private equity fund managers expect a prolonged downturn within the next two years. With that said, we currently don't see much tail off at all in the M&A world. The Tax Reform Act last year from '17, a reduction of federal government regulations and relatively inexpensive financing have all contributed to a solid M&A market. There's certain headwinds out there like tariffs, Federal Reserve interest rates, Brexit, government shutdown, China slowdown, but in the next 6 to 12 months, I don't see much tailing off. Based on your experience, Russell, what are you seeing out there? Is there any kind of a slowdown in projects?

Russell: I don't think so. I think as long as we see the change in technology, you're going to see firms looking for new ways to leverage that. Every year we're seeing new ways to deploy technology faster at a lower cost point and with a higher stickiness within the organization to be able to get the change that they want.

Shaun: Well, I think we've discussed the two really important areas that came out of the BDO 10th Annual Private Equity PErspective Survey. And I think again, in the short term, the market still looks good. Private equity firms are truly trying to reap the benefits of digitalization in their particular investments.

Russell: Absolutely, thank you, Shaun. It's good to be here today.

Shaun: Thank you as well, Russell.

TOP DRIVERS OF DEAL FLOW

Todd: Special thanks to Russell and Shaun. And now back to our conversation with Jon and David. Let's tackle drivers of deal flow, and we'll go to Jon on this one. In a highly competitive environment, dependable sources of deal flow are really more vital than ever. Private company sales and capital raises are the most cited drivers of deal flow in the next 12 months, noted by close to two-thirds of BDO survey respondents. I think PE exits were the second most cited at about 21 percent. Certainly, this finding seems to indicate a trend that PE firms are sourcing most of their deals from founder-owners, not other PE firms or frankly corporate divestitures. So, Jon, I'd like to get your thoughts. Do you expect that founder-owner buyouts are likely to become more active in the coming years as baby boomers continue to retire?

Jon: Yeah, I think that last piece there is critical. The baby boomer retirement age is coming up here, and so we're seeing more and more folks - entrepreneurs and founders - looking for exits and capital events. And so, I think that's probably driving a lot of this. And frankly, I think that's welcome news to folks like David on the other side of the table. I think you can speak to it I'm sure, but when we talk to folks in the sponsor world, they're usually more than happy to buy direct from a founder than an entrepreneur-- as opposed to from another sponsor. Not to say we don't see plenty of that, we do, but the underlying trends add up and it works for the market.

NEW BATTLEGROUND FOR DEALS

Todd: Yep. So, David, with the coffers overflowing, private equity's hunt largely remains on new deals versus add-ons or deleveraging or working capital needs with the portfolio companies. Again, back to the survey, over the next 12 months, the overwhelming majority, about 89 percent of the firms surveyed will direct most of their capital towards new deals, putting on the back burner the add-ons and deleveraging portfolio company balance sheets. I guess the real question is, is this finding in line with your expectations and what you guys are seeing?

David: Yeah. Good question. I'd say on this topic, I'm actually pretty surprised to see that result. I mean, I can obviously only speak for Gladstone Investment, but we completed four add-on acquisitions last year across the portfolio. Some really good stuff and we view them as a favorable way to achieve growth. I'd say it's pretty rare that we'll ever come into a new investment and have the mindset that we have to make add-ons in order to make the investment work. But we also view them as really nice potential upside as well, if the right target is out there. Frankly, in today's difficult multiple environments, add-ons are a really nice way to dollar average down in order to enhance growth and annual returns. Just to be fair, I'd say one of the difficult aspects of add-ons is obviously the integration piece, but at the end of the day, that really comes down to your management team. And if you've got the right management team to execute on it, which we have seen, then it can be hugely beneficial for you.

Todd: Awesome. Guys, I got to tell you, that's a lot of informative feedback from both of you. Always good to get the perspectives of an IB and a PE. Your firms are very good friends of BDO. We value the relationship, and I want to thank you both for coming today. I know our listeners are going to appreciate your feedback and your insight. To our listeners, thanks so much for tuning in. If you haven't already, we'd love for you to subscribe, rate and leave a review of the show on iTunes. Until next time. Thank you.

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