PRIVATE EQUITY PERSPECTIVES PODCAST

EPISODE 20: HARNESSING MIDDLE MARKET GROWTH OPPORTUNITIES

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

Todd: Hello, and welcome to another episode of BDO's Private Equity PErspectives Podcast. I'm Todd Kinney, National Relationship Director in BDO's Private Equity practice here in New York City. I'm really thrilled to have two special guests with us to discuss the middle market private equity landscape as well as the direct lending outlook. So, first off, I'd like to introduce Colleen Gurda, Managing Director at Comvest Partners. We're excited to have you, Colleen.

Colleen: Thanks, Todd. It's a pleasure to be here.

Todd: Awesome. I'm also pleased to introduce Jill Raker, Managing Partner at Greenbriar Equity. It's great to have you on the show as well, Jill.

Jill: Thanks, Todd. I look forward to the discussion.

INTRODUCTORY QUESTIONS

Todd: Awesome. So, without further ado, let's jump into it. Colleen, you first, as Managing Director at Comvest Partners, can you tell our listeners about your role and the focus of the firm?

Colleen: Sure. So, Comvest was founded back in 2000, and today, our funds have over $3.5 billion dollars of assets under management. We have three strategies—private equity, direct lending, and growth or non-control equity. I'm on Comvest's direct lending team. So, we're investing out of our fourth fund, a little over $1 billion dollars, and we invest primarily in senior securities so mostly unitranches. We are industry agnostic. We do a lot in healthcare, business services, and specialty finance. About half of our deals are sponsored and the other half are unsponsored. I focus on originating, executing, and managing our investments in portfolio companies.

TOPICS DISCUSSED INCLUDE:

Todd: Awesome. Appreciate that. Appreciate your background. Jill, could you do the same and tell us about your role and what Greenbriar does?

Jill: Yes, of course. I'm a Managing Partner at Greenbriar. I joined Greenbriar when the firm was founded 20 years ago. We're a middle market private equity firm that invests in market-leading manufacturing and service businesses in partnership with proven management teams. The sectors we particularly focus on include aerospace and defense, industrial distribution, logistics, transportation, and related business services. We're currently investing out of our fourth fund. We invest in all sizes, but typically are focused on businesses with $10 million or more of EBITDA. Over our 20 years, we've invested in over 30 different companies, and through those businesses, we've done over 80 add-on acquisitions. I'm on both the firm's management committee that governs the firm and our investment committee. I also co-lead our efforts in the logistics sector, which has been about 25% of our investments. And I currently sit on the board of three of our logistics companies, LaserShip, a regional parcel delivery company, and two freight forwarding businesses, BDP and SEKO.

SHIFTING STRATEGIES

Todd: Just a few responsibilities there, huh? Pretty impressive. All right, so Jill, we'll stay with you for this one. You've been with Greenbriar Equity since its founding a couple of decades ago. I guess the question is, in what way have you seen the end markets you invest in change over time?

Jill: Good question, as some of our markets have changed more than others. Let me touch on the logistics sector because that's been one of the more dynamic areas. Let me touch on three themes. The first has been shifting global trade patterns. For 15 of the past 20 years, global trade has been a major theme with companies extending their supply chains all over the planet, and global trade growing at two to three times global GDP. That's created a lot of opportunity for logistics companies to help navigate the complexities of international trade. Of course, more recently, the pendulum has shifted to a theme of protectionism and nearshoring. But in any case, the change creates opportunity for 3PLs as they help clients navigate those changes. A second theme has been rapid e-commerce growth. It's amazing to think about 20 years ago how we ordered goods, and today we're all ordering on Amazon. And we expect everything to come tomorrow because they've trained us that we need it tomorrow, even though we don't need it for a couple of days. The result has been tough for traditional retailers but terrific for logistics. It's resulted in a proliferation of distribution centers because the inventory needs to be close to us as the consumer so we can get it next day, and growth in last-mile transportation. The third theme I'll touch on is just technology driving cost efficiencies within the supply chain. The most obvious example of that that we're all familiar with is Uber who cleverly taps the passenger car fleet which we all have sitting in our garages, and they opened up that underutilized capacity to anyone with the smartphone who wants to book a ride. It's a great example of technology streamlining the process and improving asset utilization. That said, technology doesn't solve everything. Moving freight is more complicated. And technology can help make it more efficient, but it doesn't often remove the need for a 3PL to take ownership with the process and manage exceptions. We focus on areas where technology is a tailwind and stay away from opportunities where technology disruption or changes out of our control, can surprise us. So those are a few of the things we've seen in logistics the last number of years.

DIRECT LENDING OUTLOOK

Todd: I appreciate your insight. Definitely some important takeaways for our listeners. Now, we'll turn to Colleen. Let's do a deeper dive here into your specialty for a little bit. You work in direct lending space as you said. Can you tell us more about that as well as some of the advantages of the direct lending strategy?

Colleen: Yeah, sure. Thanks. So, alternative lending really fills the gaps that have largely been vacated by the traditional senior lending market. What we're providing companies is fairly priced, efficient, one-stop financing for them to grow their business, acquire other businesses, or do recapitalizations. We're typically used as a unitranche loan, so the company are the sponsors, not negotiating with multiple parties or dealing with the intricacies of an inner creditor agreement. And when we look out on the opportunity, we're often able to get that opportunity done and closed within 30 days of signing a term sheet.

COFFEE BREAK WITH BDO'S KRISTI GIBSON

Todd: Thanks, Colleen. Certainly, an interesting perspective on alternative strategy to PE. Now, let's hear from our Coffee Break guest, Kristi Gibson, who's based in BDO's Dallas office. Kristi co-leads BDO's National Real Estate practice. Let's hear her insights.

Kristi: Thank so much Todd. We certainly have some talented guests here with us today.

I thought I would start broadly discussing shifting strategies within PE and then move towards real estate specifically. Broadly speaking, I think we have seen, and will continue to see, shifting strategies based on capital's natural desire to be free. And what I mean by that is capital will almost always flow in the direction of the path of least resistance where money can be made. Proof of this can be seen in the shift in the last 20 years away from publicly listed companies in favor of private equity. When surface tension or an obstacle is introduced into an existing capital path, capital will naturally flow in another direction, similar to rainwater flowing down a street. When the rainwater encounters an obstacle such as a parked car or a branch lying in the road, it naturally finds the path of least resistance to continue its flow. In the last 20 years we have seen a dramatic increase in public company regulations – our surface tension or obstacle in this case – which has led, in large part, to a decline in IPOs. Our publicly listed companies are nearly half of what they were just over 20 years ago as capital has naturally flowed to private equity deals. We are now even seeing the most traditional of publicly traded stock market investors such as university endowments moving into the PE investment space.

This same concept holds true in a more micro setting when looking solely at real estate. We see PE capital flowing to different real estate sectors based on the path of least resistance. For example, in the last several years we have seen significant amounts of capital flowing to senior living based on the metrics of an aging baby boomer population. However, as obstacles to this sector have been introduced, such as our silvers having overall better health care and thus living longer, coupled with their desire for more amenities than the traditional senior living facility has to offer, they have opted to move into active adult communities rather than traditional senior living facilities. This has led to an oversupply of beds in the traditional senior living facilities which is projected to last for up to 10 years until the baby boomers are in a position where they must move into assisted living facilities. As a result, private equity capital is now shifting away from this sector.

Another example, and dovetailing into Jill's comments on logistics, relates to PE capital flowing into real estate's industrial sector to meet the consumer's appetite for on-demand delivery. As a result, we are seeing the modernization of existing industrial properties in high demand HUBs such as San Francisco, Philadelphia, Houston, Dallas and Phoenix with the reconfiguration of existing footprints to their "highest and best use". We have also seen the use of innovation such as robotics in this sector. So, while there is no room within the city center HUB's last-mile delivery centers to expand outward, they are expanding vertically and using robotics to reach the storage heights previously unattainable by humans and prior existing machinery. However, we are already seeing that modernization of these existing facilities will not meet projected demand and so we will see additional industrial properties being built with a continual outward migration from these aforementioned HUBs. This outward migration and increased consumer demand will then create additional transportation holes which will need to be filled.

According to the American Trucking Association, a shortage of drivers is likely to increase to 100,000 in the next 5 years increasing the demand for automated trucking. It will be interesting to see how the trucking industry evolves to meet this demand. Will truck drivers become more like U.S. drone pilots, operating from a central facility close to home so they can go home to their families at night? Or will our trucking fleets be entirely automated requiring much less human capital to operate? Time will tell, but private equity backed start-ups have emerged in the last few years to automate the trucking industry with promising success. UPS, Amazon and others are currently partnering with these PE backed start-ups and experimenting with this technology.

I think we will also see an increase in public-private partnerships to meet the ever-increasing demands of the consumer. City suburbs willing to team with PE and invest in rail and regional airports will benefit from this outward migration of industrial real estate. By way of example, Dallas is currently leading industrial development nationwide with 35 million sq. ft under construction. One of Dallas' northernmost suburbs, McKinney, just landed a major 65-acre logistics industrial project due in part to the city's investment (via a public-private partnership) in a regional airport which can support cargo. This is noteworthy since, generally speaking, these last-mile delivery centers are no more than 6-to-9 miles outside of major population centers and this project would be 30 miles outside the Dallas population center.

So, in conclusion, we can see that when evaluating how capital will flow, the same rules hold true from a macro and micro perspective. Assuming it can produce a benchmarked ROI, capital will be free and strategies will naturally shift based on paths of least resistance. Back to you, Todd.

Todd: Thanks for sharing your insights, Kristi.

MIDDLE MARKET OVERVIEW

Now, let's return to our conversation with Colleen Gurda and Jill Raker. As you may know, BDO's clients are primarily in the middle market and for both Colleen and Jill, looks like yours are as well. So, let me ask you this. What are some of the special challenges and opportunities of working with companies in this sector? I guess Colleen, I'll throw it to you and then let Jill chime in with her thoughts.

Colleen: Great. First, I want to define what we think of as the middle market which I know Jill also agrees with—it's companies that have $50 million to $1 billion of revenue. It's a huge segment of the US economy, more than 200,000 companies, most of which are privately owned, many of which began as small entrepreneur of family-owned businesses and have survived recessions and competitions from larger, better capitalized competitors. They've long outgrown the venture capital market yet are too small to consider being public. The right management focus most have the opportunity to increase their operational efficiencies, grow market share, and become more valuable enterprises. So, the challenge is that we see generally relate to scale or I should say a lack of scale. They're often regionally focused and concentrated in terms of customers and supply chain and often find it challenging to grow and compete globally. I think perhaps the biggest challenge is also attracting top-tier management talent and experience which a lot of the times leads to opportunity.

Todd: Yeah. Jill. Care to share your thoughts?

Jill: Sure. I agree with those issues that Colleen highlighted. For Greenbriar, we're typically investing in businesses that have experienced great growth, have a differentiated business model, and have a terrific top executive team. But they're often stretched from a human capital perspective. Their business intelligence is weak, and their processes are not fully formed because they've been figuring it out along the way but may not be invested in some foundational items. These issues are what creates opportunity for us in the middle market. We invest in people as needed to supplement the executive team. For example, with an EVP of HR or adding to middle management. We'll take time for more in depth strategic planning, setting priorities tied to equity value creation, and ensuring the incentives are aligned. We'll certainly invest in better business intelligence, in the form of dashboards with key information that include exception management, and push that down to the organization for better, quicker decision-making. And then, regarding the foundational items, that's case by case, but often relate to processes. The businesses may have grown significantly, but the processes haven't fully caught up. So, we could use lean type initiatives to ensure consistency and strive for best practices across functions in the organization. Finally, on the growth side, often organizations haven't gotten to M&A yet, or they haven't fully standardized their M&A practices, so that's certainly something we can help for growth, or we can look to international growth as an opportunity. So, to wrap it up, the issues that middle market companies face are often the opportunities for us to create value.

Todd: Yeah. Thanks to both of you. Appreciate the insights. I can say at BDO, we certainly agree that working with middle market companies is continually a rewarding experience. Now, according to BDO's US Private Capital Outlook 2020 survey, both PE and VC respondents to the survey cited increased competition as the top challenge to closing deals and investments in the current environment. So, Colleen, I'll throw it to you. Given the elongated bull market, what attributes of loans or companies are you looking to invest in given the potential economic slowdown?

Colleen: A good question. Yeah, so throughout this period of economic expansion our investment strategies remain fairly constant. We've been providing leverage from three to, say, four and a half times, but with an intense focus on not losing principal. This translates to strong due diligence process and conservative view of risk. We tend to focus on company fundamentals like fixed charge coverage, cash flow generation, and margins. Also, at this point in the cycle, we like to look increasingly at the last several years of performance and not just the last 12 months. We're also more judicious when it comes to add-backs and pro forma numbers versus actual earnings.

Todd: Yeah. Good points. Speaking of increased competition, how have your firms been navigating the crowded and expansive market? And I guess, the second part is what do you do to keep finding good deals? So I don't want you to give away the secret sauce, but share what you want to with the listeners. I guess, Jill, why don't you take it first? And then we'll have Colleen add her comments.

Jill: Sure. A couple things. The first is deal size. I mentioned earlier that we typically shoot for businesses with 10 million or more of EBITDA, but more recently, we've invested in a couple of businesses below that threshold where we have a line of sight to an add-on acquisition that will help scale it immediately. We benefit in that case because smaller businesses typically trade at a lower multiple, so that's allowed us to find some interesting entry points in sectors we know well. A second piece is we've tried to stay really picky and disciplined about when we participate in auctions. When we do enter a competitive process, it takes time, and of course, there's competition. So, we want to ensure it's a strike zone area for us that we can diligence well, and we look for situations where we can bring value add. Everyone in the process receives the same CIM, the same management forecasts, so we need to have our own ideas of how we can help management supplement their plan if we're going to succeed. The last theme is that we rely heavily on a proprietary sourcing engine, which is about half of what we invest in. We have the benefit because we've been focusing in the same areas for 20 years, so we've been proactively meeting terrific companies, expressing interest to them to think of us as their capital partner when the time is right. As an example, our most recent logistics business that we invested in, we first met 15 years ago. And they felt no compulsion to run a process. They knew fair value and they trusted us, and we've got something done with them outside of a process. So, there are some ways to navigate a crowded market and find good deals.

Todd: Appreciate that. Colleen?

Colleen: Yeah. So, I guess from a direct lending perspective, while we are a direct lender, we don't play in the traditional sponsor lending market. We know we won't be competitive, or for that matter, don't want to be competitive in a straight down the fairway sponsor deal where leverage is deep, there's a thin equity check, and covenants are loose or non-existent. So instead, we look for deals that are not non-sponsored or have some sort of non-traditional sponsor, i.e, an independent sponsor. Also, in industries we know, so health care services, specialty finance, and a few others, we're able to get comfortable with more situations or tougher underrates, such as customer or supplier concentration.

Todd: Yeah, I think you gave us some insider knowledge without giving away the secret sauce. I know our listeners will appreciate that. Colleen and Jill, Comvest and Greenbriar are great relationships at BDO. We appreciate all the business that we get to do with your firms. And I know you're busy, so thanks for taking time to join the podcast today.

Colleen & Jill: Thanks. Thank you for having us. We appreciate it.

Todd: Of course. And 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, this is BDO's Private Equity PErspectives.

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