



# 4Q 2018 PE Insights

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EisnerAmper is among the nation's largest accounting firms with a dedicated and well-established private equity services group providing audit, tax, and advisory services to private equity firms and their portfolio companies. From start-up funds to large and complex financial entities, our dedicated team understands client needs and provides strategic advice and innovative approaches.

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Client-Focused



Integrity



Solution-Based



Deep Relationships

EisnerAmper's private equity professionals understand the unique needs and strategies of private equity firms. Throughout the life cycle of a fund, we deliver timely value through our audit, tax, transaction and other specialty services. Our goal is to provide both private equity investors and their portfolio companies with the close personal attention necessary to help them achieve significant and sustained growth.



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## Executive summary

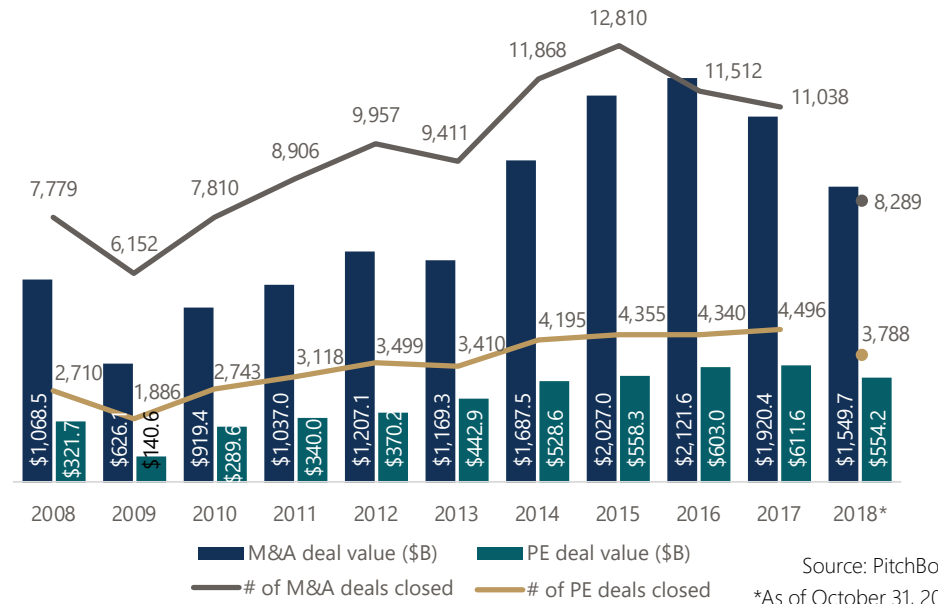
- **Private equity (PE) may account for half of all M&A soon.** PE has become an increasingly important part of the M&A cycle. In fact, it's possible half of the entirety of M&A volume could be driven by financial sponsors within the next five years. This would represent an unprecedented proportion and signify one of the clearest signposts for the institutionalization of PE.
- **PE has institutionalized against a remarkably strong M&A backdrop.** Chief drivers are: 1) unprecedented accommodative monetary policies enacted by central banks across the globe; 2) a swift recovery by public equity markets since the financial crisis; and 3) coinciding, mutually reinforcing industry and innovation cycles.
- **The PE paradigm has slowly evolved in the past decade.** Private markets are an increasingly important avenue of growth. PE fund managers have had to grow ever more creative in their sourcing and deploying of capital.
- **Dealmaking gets creative.** Amid heated auctions for the best assets, PE firms have been able to keep up a steady pace of dealmaking by ramping up the rate of growth investment, as well as increasingly turning to add-ons. This rise in dealmaking has not only propped up overall M&A, but also has grown to become increasingly important—perhaps one of the most important drivers of the M&A cycle.
- **Trouble could be on the horizon for the unwary.** Competition is the most pressing factor that could diminish PE activity, as fund managers have to work harder to justify pricey acquisitions. But should markets remain tumultuous or an economic slowdown transpire, PE firms still enjoy long holding times and must continue to invest their mountain of capital, so they may very well still end up accounting for half of all M&A worldwide.

## Macro take: PE grows in stature in M&A

Since the depths of the financial crisis in 2009, M&A activity in the United States has gradually risen in a nearly unmatched crescendo, cresting in 2015 at 12,810 transactions completed across more than \$2 trillion in aggregate value. Since that peak, moreover, the cycle has hardly slackened; aggregate annual tallies of value have barely fallen below \$2 trillion, and volume has never declined below 10,000. It's worth noting that this sustained run is in large part due to the role played by financial sponsors. PE activity has been an increasingly important supporting player in overall M&A, maintaining a steady clip of dealmaking for several years now, even as transaction multiples have steadily climbed. And in light of recent market turmoil, it's possible PE may remain steadier, somewhat insulated from the quarterly cycles that many publicly traded companies must endure.

What has driven these convergent and related trends? Analysis of the global macroeconomic landscape lends a great deal of context and insight into why this

US M&A and PE deal activity by year



cycle has been so strong. The first of several key factors has been the historic degree of accommodative monetary policies adopted by central banks worldwide. As the stock market roared back in the now-longest bull run for the

S&P 500 in history, rising share values also augmented resources to employ in additional M&A, while investors in PE funds had to increase their commitments to keep portfolios proportional, which further fueled PE activity.



### Carveouts

Recent market turmoil could lead to M&A opportunities

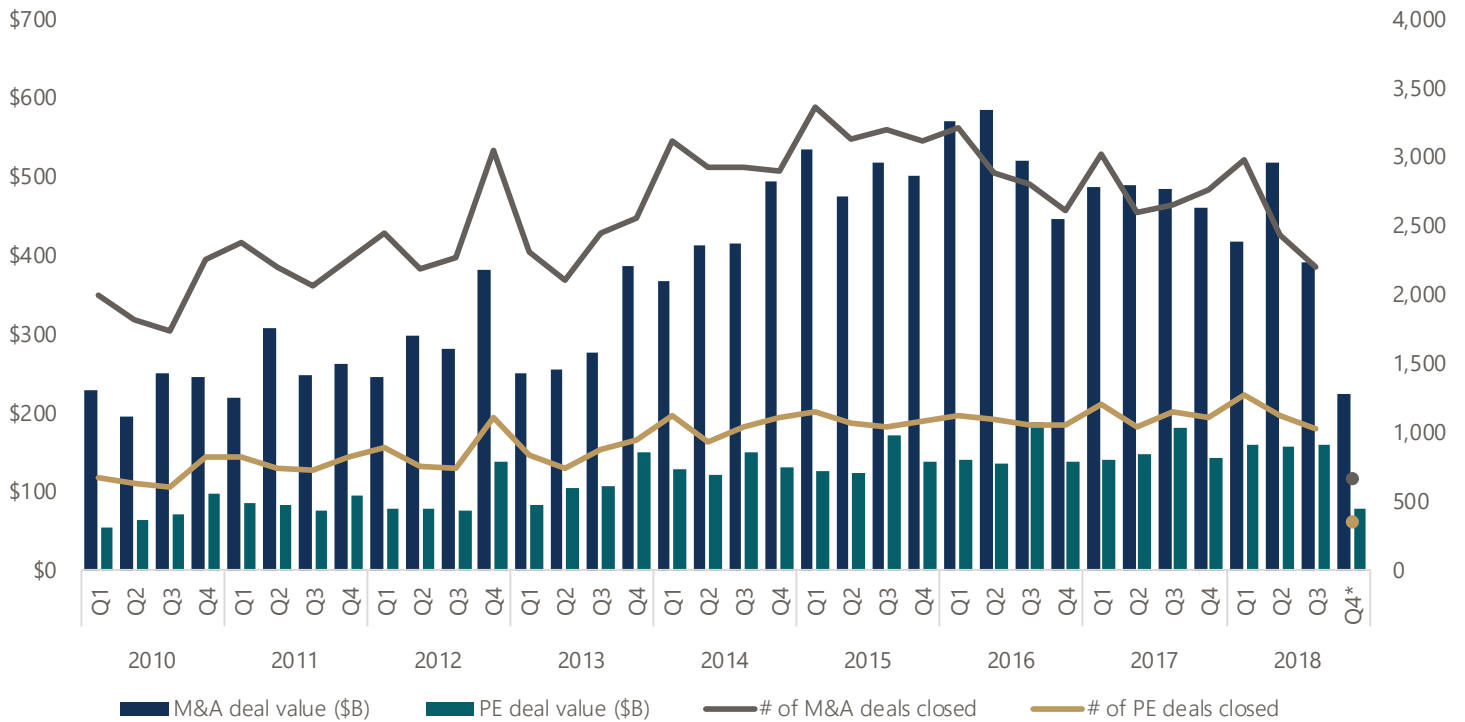


### \$7.6 B

in aggregate M&A value from 2015-2018\*



### US M&A and PE deal activity by quarter



Source: PitchBook  
\*As of October 31, 2018

Last but not least, industry and innovation cycles coincided to encourage M&A. Take digital commerce platforms, for example. Online retail began to eat into traditional brick-and-mortar stores' share of total dollars spent, eventually prompting the

shuttering of thousands of stores across multiple chains. Although digital and physical retail will eventually arrive at a more harmonious, complementary co-existence, that is just one of the examples of digital innovation disrupting incumbents, which

can contribute to acqui-hires or outright absorption of startups. Industry cycles have progressed in tandem, with consolidation across multiple industry segments, e.g. healthcare services in response to climbing costs of care also slowly progressing into a driver of aggregate M&A.



# Consolidation

Booming asset values led to proportional increases in PE commitments

## Q&A: Late cycles and evolving markets

### **What's your general take on the current M&A environment, and then for PE specifically?**

Capital raised in the market continues to be quite high, and investors are deploying that at a fair clip. In today's environment, everything comes down to an auction. As the market has matured, the sophistication of buyers and sellers has increased, which has put a greater emphasis on the diligence process, with investors now also undertaking more specific industry diligence. For PE in particular, because of competition for deals, multiples are still high. Firms at the lower end of the size spectrum—let's take independent sponsors—are at a disadvantage in the market, because, all else equal, of lack of access to a fund and immediate source of capital.

### **What are the characteristics of the PE firms that are currently having an easier going of it currently? Is it mainly due to scale?**

It's not really size, but rather focus. As the market's matured, you have various PE groups that have focused on specific industry niches. Even if a PE group would call itself a generalist, there are usually about three different segments where they actually concentrate their time. Bigger isn't necessarily better. You don't see funds doubling in size from one successor to the next. You see a more persistent focus on small-cap firms, mid-cap firms, etc.

### **What are your thoughts on the environment as 2018 winds down, relative to where we started the year?**

I've seen no indication that would lead me to believe deal activity would slow. The underlying performance of the seller continues to be strong. The economy looks strong, and consumers remain optimistic. Combined with the availability of capital, the situation looks promising. On the flip side, however, as we prepare clients for a sales process, an emphasis on sell-side analysis continues to be heavy even for relatively clean companies. Many investment banks would require a report on quality of earnings on the sell side, especially if the company was privately held and not audited. Even healthy companies are going through the process now just to ensure there are no surprises.

### **What are the biggest concerns prompting due diligence?**

Speed of close. In the last several years, we've seen timelines begin to compress. One key factor behind this has been availability of debt. Our recurring PE clients typically have a shortlist of lenders with whom they've built relationships, which helps expedite processes within the current market.

### **From your perspective, are lenders increasingly cautious?**

Lenders express concern, but not every lender follows through. There's an availability of capital within debt markets to such a degree that some conservative lenders get passed by more aggressive competitors, while larger banks come in with unitranche loans, which can bypass mezzanine lenders. Basically, undercutting standards in any way usually sparks talk of a lack of caution.



### **John Ruckstuhl Managing Director**

John Ruckstuhl is a Managing Director in the Transaction Advisory Services Group. He has 20+ years of experience advising PE and VC firms, as well as their portfolio companies, on domestic and international transactions. His experience also includes financial analysis for debt restructuring, carveout transactions, reverse due diligence (including quality of earnings assessment and preparation for sale) and analyzing financial projections, cash flow models and working capital.

John has diverse experience with both public and private clients across a variety of industries, including consumer products, food and beverage, manufacturing and distribution, and more. He has private company experience as the controller of a global provider of relocation management services to Fortune 500 companies, responsible for all aspects of financial reporting and compliance for offices worldwide, as well as global treasury management and transaction processing.



### **Within add-ons—which are in vogue—what areas of due diligence do you see firms focus on most?**

Much of that will be case-specific. If you have a target company with customer concentrations that would preclude someone from looking at them as a platform, that's a perfect add-on. You start to see more focus on the customer population due diligence and how it complements the platform company's audience.

### **Which areas of due diligence are more in demand nowadays relative to a few years ago?**

This will be an EisnerAmper-specific response, of course. We have focused a lot on taxes in general, as well as tax structuring. We have also increased activity in financial due diligence, particularly regarding PE. Lately we've pushed to expand into IT due diligence, particularly cybersecurity risks. Any firm holding customer data is increasingly aware that it needs to understand potential exposures, how security is compartmentalized and what level of risk it is bearing. That area of diligence is still underserved, frankly. A lack of follow through is apparent. Is it better not to know you have a risk, or is it better to know you have a risk and not to do anything about it?

Within the middle market, it's not just about identifying risk, but also the cost-benefit analysis of follow through. Smaller companies that don't have a robust internal IT group may find it difficult to justify some costs. In acquisitions, does a target company's management always understand its exposures? Especially if a business has other small businesses' customer information within a given cloud-based system. How secure is that system? Some small companies utilize only Google Drive, for example.

### **How do you handle advising companies regarding best practices within this arena?**

From an ERP perspective, it comes down to the best possible option. For example, QuickBooks has become much more robust. On the other side, I recall a consumer distribution company spending millions of dollars over the years investing in SAP, which was unnecessarily complex. Even as we look at companies with flaws in their internal IT environment, many of the considerations do come down to the investor's perspective, e.g. their holding period.

### **What other red flags, in general, do you see that don't normally get addressed?**

As the market continues to get smarter, there isn't much change in the way of customer due diligence. What I have seen, and which will continue to move forward, is procurement and supply chain diligence. PE has been really good at reducing overall cost burden. Firms focus on top-line growth, which can be initially augmented via add-ons initially. Yet they also focus on the bottom line, i.e. taking costs out of procurement.

This is especially relevant in the current environment, where secondary buyouts are quite common. PE sponsors looking at other PE portfolio companies must examine how much more value and scale a purchase can drive. When it comes to that chain of value, affairs have changed somewhat as growth equity players have inserted themselves in between the phase of VC and mature PE. That trend was driven in part by the rising costs of IPOs encouraging companies to continue growing privately. Why not opt for a PE group with specific

industry expertise? Or an operating partner who is a former CEO who can provide strategic direction? Or a former CFO who can help optimize financial results? You don't get that by going public.

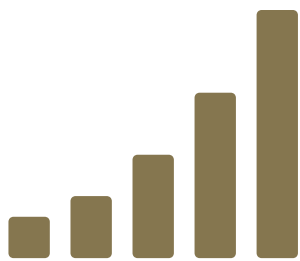
### **What other topics did you wish to address?**

When it comes to add-ons, incorporating synergies and redundant costs into the due diligence process is important. I often work with clients on two primary areas: one, where synergies that have already been identified are properly vetted, and two, additional areas where there may be opportunities post-close. From an accounting perspective, firms used to shy away from doing anything synergy-related, but now it's more widely accepted.

Regarding the auction process, we generally don't get involved until the client has a letter of intent in place. What has become increasingly discussed across all acquirers with whom we work—but especially PE firms, given the level of competition in the marketplace—is conducting pre-LOI analysis, especially while working with equity groups that require supplementing of their internal staff on matters such as management presentations. It's all just to vet opportunities more quickly, optimize investigations and identify anything that could impact valuation, even before the typical LOI stage. That way, those firms can focus their internal resources on deals that are likeliest to move forward. A little due diligence early can save a lot later.

## PE in depth: Increasing institutionalization

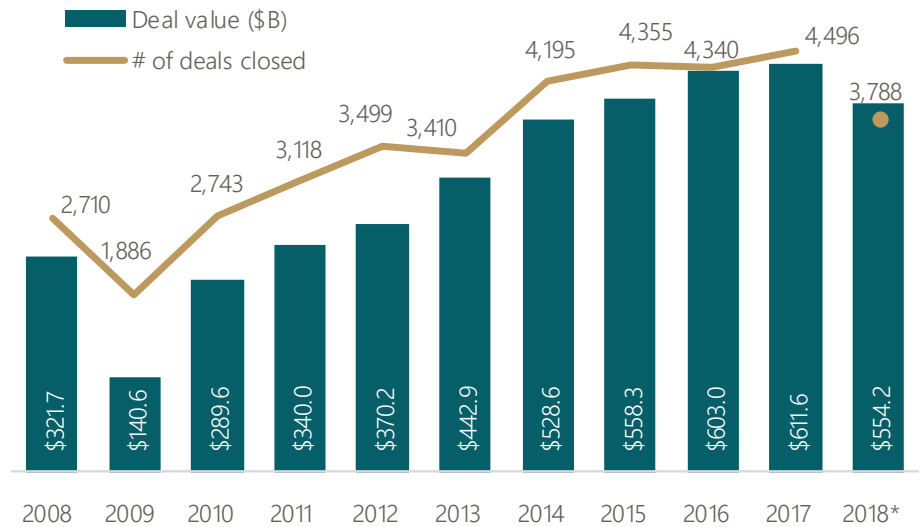
The PE paradigm has been transformed, albeit in unexpected ways, in the past decade. Although many portfolio companies were hit as hard as any others during the recession, by and large, multiple fund managers were able to rebuild gradually and take advantage of the M&A cycle and bullish public equity markets to eventually exit holdings, returning massive distributions to their backers. Such strong results and aforementioned low interest rates, not to mention the gradual compression of hedge fund returns, ensured even more capital was pledged to PE's niche in the alternatives space. As capital flooded into PE funds, valuations for private companies coming to market inevitably rose in the midst of intense competition for higher-quality businesses and new entrants into the market. Still-liberal lending practices didn't hurt, either. As competition has risen, concerns around PE outperformance persisting have too. Yet many firms are able to keep raising massive sums, and PE is becoming increasingly institutionalized, extending its reach even further into the middle market.



# \$51.3M

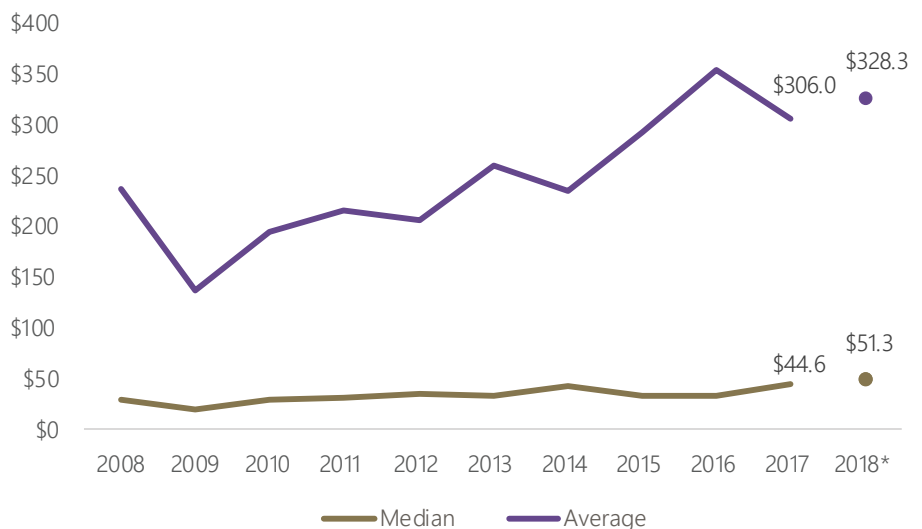
Median PE deal size hits a new high in 2018 to date

US PE deal activity by year



Source: PitchBook  
\*As of October 31, 2018

Median & average US PE deal size (\$M) by year



Source: PitchBook  
\*As of October 31, 2018

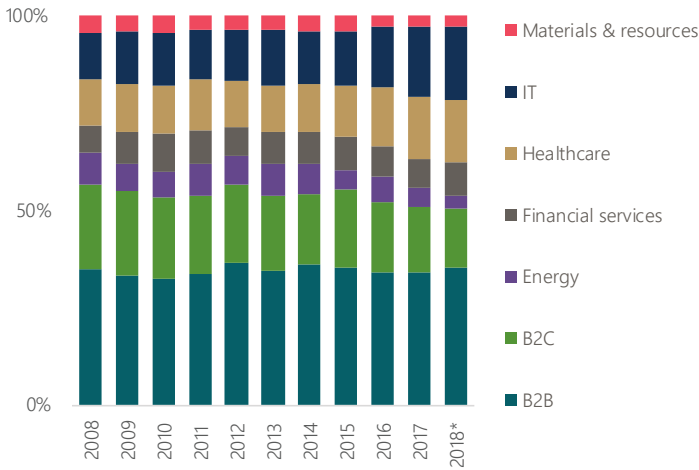


As firms push further into the middle market in the US, reviewing how much pricier general M&A has become, as seen below, underlines why they are doing so. Another trend that stands out clearly below is the

increase in PE activity within IT. Not only are fund managers buying IT companies more frequently, they are spending hefty sums in doing so. Much of this activity is concentrated in SaaS offerings currently, as

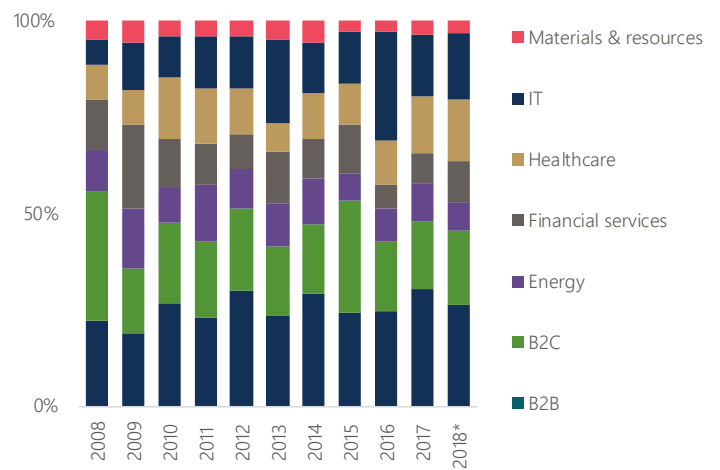
enterprise software companies grow more institutionalized across verticals. Healthcare is also consolidating, which PE buyers are eager to gain exposure to via building out their own platforms.

**As PE grows more institutionalized, firms push into IT**  
*US PE deals (#) by sector*



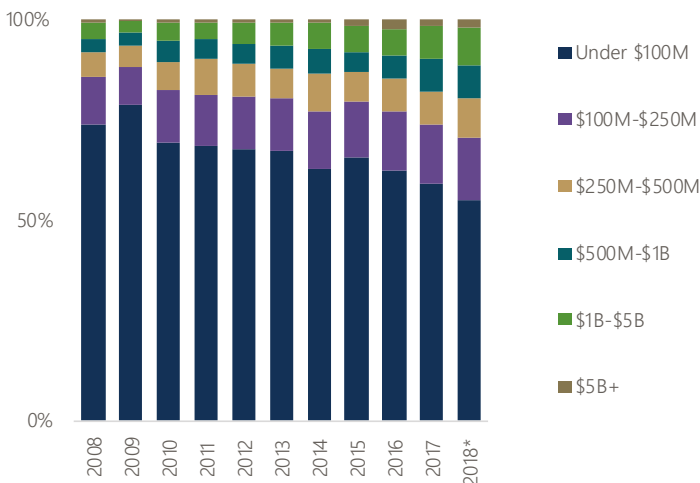
Source: PitchBook  
 \*As of October 31, 2018

**Healthcare and IT draw more and more dollars**  
*US PE deals (\$) by sector*



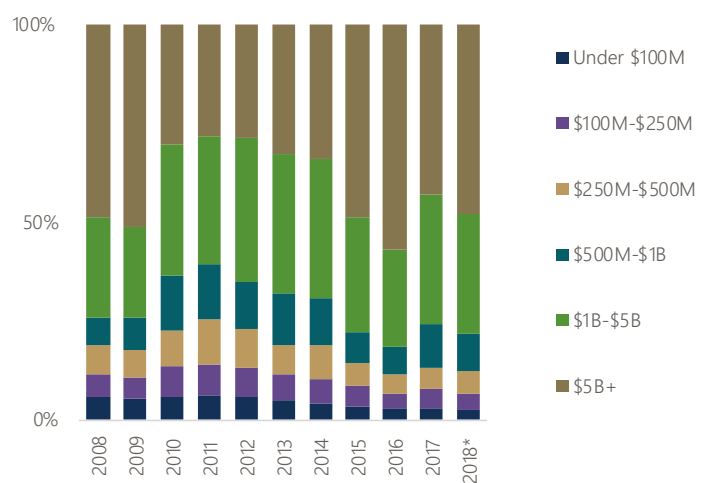
Source: PitchBook  
 \*As of October 31, 2018

**Late-cycle M&A grows pricier**  
*US M&A deals (#) by size*



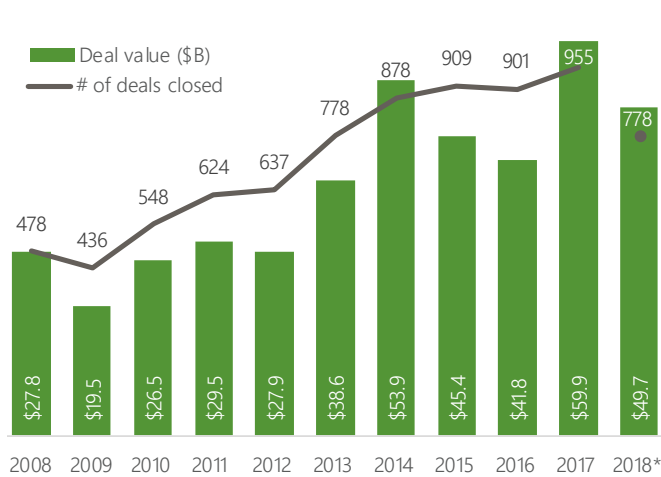
Source: PitchBook  
 \*As of October 31, 2018

**Mega-deals become the norm, pulling in even PE players**  
*US M&A deals (\$) by size*



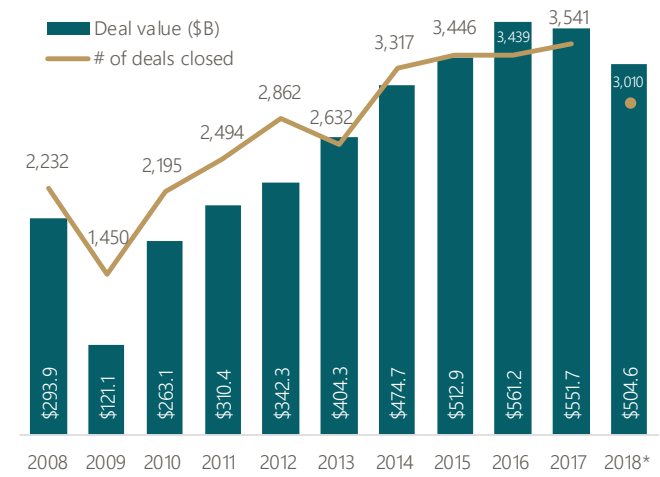
Source: PitchBook  
 \*As of October 31, 2018

## US PE growth deal activity



Source: PitchBook  
\*As of October 31, 2018

## US PE buyouts deal activity



Source: PitchBook  
\*As of October 31, 2018

As valid as concern around PE performance persisting is, it has not yet demonstrably slowed the pace of PE dealmaking. However, it has resulted in considerable adaptation in fundraising and sourcing strategies. To take one highly pertinent example, growth investing reached a peak in deal value at \$59.9 billion last year, the highest annual sum of the decade. Although that former sum also reflects heightened valuations, the impressive volume speaks to its overall popularity. What is notable about the rise in growth investing is the degree to which even traditional buyout shops are embracing minority positions in fast-growing technology companies, among other businesses. Beyond typical adaptations, a relatively new development is the fact that some private companies large enough for PE firms' typical purview would rather elect for PE funding than go public as used to be the case.

But that evolution does lead to a potentially controversial conclusion. If PE firms are increasing the scope of their typical investing strategies yet retaining the classic characteristics of long holding times, their

activity could become an even more important sustaining factor in the overall M&A cycle. In fact, it is not inconceivable that PE's portion of the overall M&A cycle approaches half of all volume in the future,

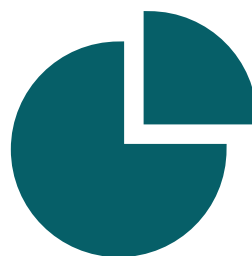
as private markets grow to constitute an increasingly important component of not only capital markets in general but also the business landscape.



PE firms on pace for well over

# \$600B

in deal value for third consecutive year



PE activity's portion of general M&A by volume nears mammoth

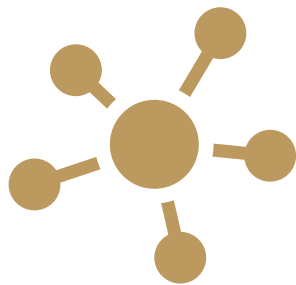
# 45%



# Highlights: PE's evolving strategies

Add-ons have become increasingly popular. Not only does it help mitigate initial purchase prices by baking in potential, additional acquisitions, the platform-building strategy is also predicated upon sourcing in often less-expensive if more challenging smaller markets. It should be noted that they are not foolproof for avoiding paying still-expensive multiples, as even the lower middle market has become pricier as of late.

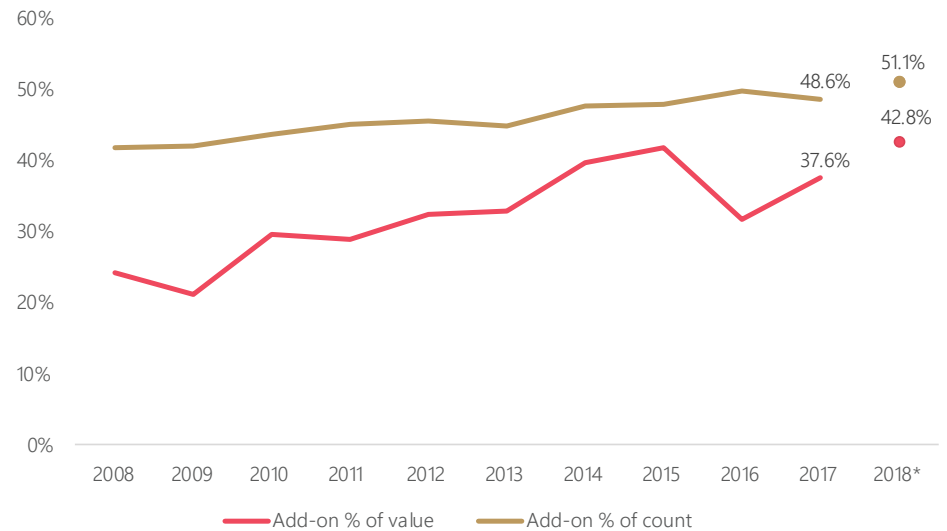
However, the virtues of add-ons still by and large appeal to many PE investors. In fact, they've become so widely used to the extent that anecdotally PE buyers have approached auctions for a core platform business with additional add-on opportunities already lined up to have a better shot at winning the bid. Their popularity seems highly unlikely to diminish anytime soon. Furthermore, their sheer number could underpin PE's rise in M&A proportion, or at the least help maintain it.



Add-ons have accounted for over half of all PE activity by count, and by value over

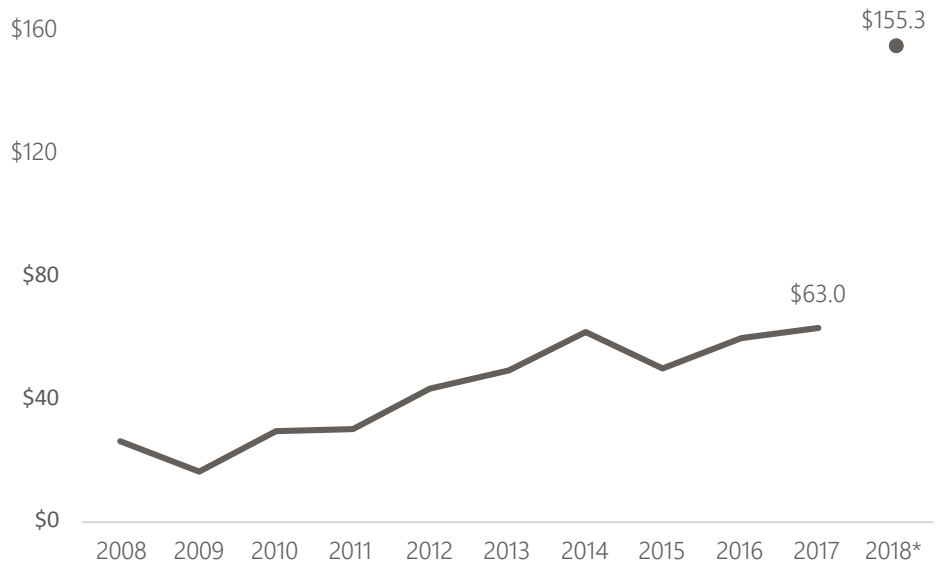
# 40%

### US PE add-ons (\$M)



Source: PitchBook  
\*As of October 31, 2018

### Median US PE add-on size



Source: PitchBook  
\*As of October 31, 2018



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