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PErspectives

on U.S. Middle Market Private Equity

Contents

Introduction

The market for sub-$1B funds is different: What investors need to know

Private equity (PE) for sub-$1B funds is in many ways different than the higher end. Compared to the higher end of the middle market, at the time of acquisition portfolio companies tend to have leaner management teams and be less mature with fewer systems and processes necessary to support their growth. Multiples tend to be lower, reflecting the additional work needed to grow them and increase their profits. Akerman focuses predominantly on this end of the market, which has its own unique risks and rewards system. Even so, this end of the market is still competitive, and investors and companies alike feel the pressure. In today's environment, investors, companies and advisors alike need to be nimble, and it's imperative for advisors to have efficient and flexible processes in place to meet the needs of their clients.

The process is often more personal at this end of the market. Investors looking to buy companies from their founders (and their families) need to recognize that these deals often include an emotional element that isn't common at the corporate level. Purchasing a company from its founder isn't just a "transaction" for the seller. It's a significant life development, and investors and advisors who recognize that sensitivity are more likely to succeed in this market.

This report looks to shine a spotlight on that market and particularly on the PE funds (broken out by sub-$500M and sub-$1B funds) that are seeing the most opportunities within that market. Investors have a mix of optimism and hesitation today. The numbers are important, and PitchBook data presents evidence of both. But approaching transactions the right way is critical, and, like every frothy market, a need-for-speed approach to closing transactions is a reality. Investors need to focus on the things that matter. Akerman has years of experience advising on transactions in the middle market, where the consequences of imprudent investment decisions can be devastating. But there are benefits for investors who effectively navigate the landmines, which include changes to the tax law (see pages 7-10), the importance of representation and warranty insurance (pages 14-15), and the more personal touch needed to close those transactions.

Purchasing a company from its founder isn't just a transaction for the seller. It's a significant life event, and investors and advisors who recognize the emotional element are more likely to succeed.

Akerman LLP is a top 100 U.S. law firm recognized by *Financial Times* as among the most forward thinking firms in the industry. Its more than 700 lawyers and business professionals collaborate with the world's most successful enterprises and entrepreneurs to navigate change, seize opportunities, and overcome barriers to innovation and growth. Akerman is known for its results in middle market M&A and complex disputes, and for helping clients achieve their most important business objectives in the financial services, real estate, and other dynamic sectors across the United States and Latin America.

The Akerman Corporate Practice Group advises public and private companies, including private equity funds, on M&A, capital markets, financings, and other transactional matters, with a strong focus on the middle market. Akerman is top-ranked nationally for mergers, acquisitions and buyouts: middle market by *The Legal 500* and is recognized as a leading U.S. law firm by *U.S. News - Best Lawyers* for corporate, M&A, private equity, securities/capital markets, securities regulation, and banking and finance law, and is listed in PitchBook league tables as among the most active law firms in the United States for M&A deals.

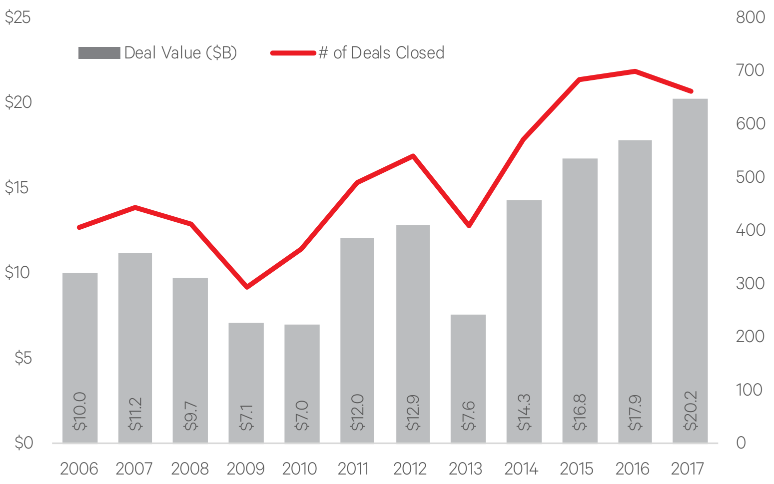
sub-$500M funds
Deal Flow

Deal activity was down slightly in 2017 in this sector of the market (funds less than $500M), as were purchase price multiples. However, compared to historical norms, both remain elevated. Last year's deceleration in multiples was a sign of discipline and cautious optimism among investors, who are facing headwinds of increased PE competition, high valuations and the increased activity of fundless sponsors. In all, about $20.2 billion was invested in 2017 via 662 transactions. Overall value was up slightly from 2016 ($17.9 billion), reflecting higher than normal price tags and the amount of new capital in the market, which totaled $16.9 billion last year.

The PE market has enjoyed a historically long business cycle and historically low interest rates. The market is cautious at the moment. Investors have found it harder to find good companies selling at good multiples, and additional work is being done to find potential value. To mitigate today's multiples, sub-$500 million funds have taken to add-ons in large numbers as a way to achieve multiple expansion. The 363 add-ons done in 2017 represented 55% of total deal activity, and the $5.9 billion spent on add-ons last year was a record.

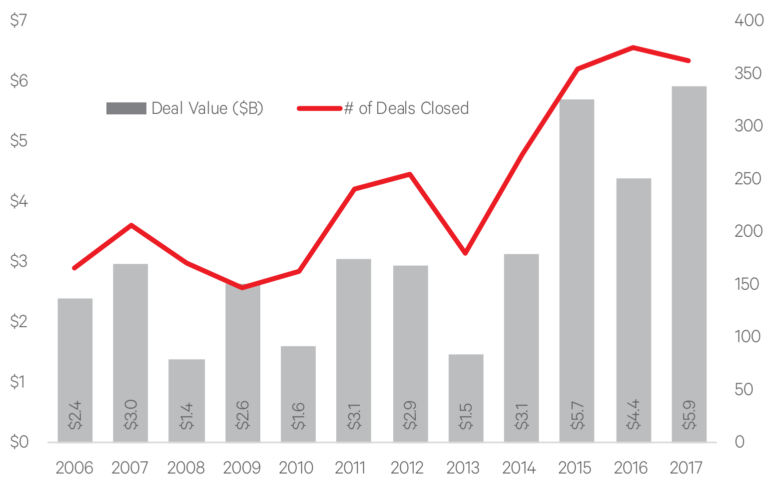
Valuations remain high by historical standards. For deals done at enterprise values less than $100 million, the median valuation/EBITDA multiple was 6.8x in 2017, including 3.6x debt contribution on a median basis. Because interest rates remain as low as they are, PE returns will not be overly sensitive to increases this year if the Fed's planned hikes are done at a modest, structured pace. There is risk, however, if rate increases are done in a disorderly or rapid manner, which has occurred in the past. Those types of scenarios are typically correlated with an economic downturn. Disallowance of certain interest deductions, the reduction in the corporate tax rate and the increasing use of Internal Revenue Code Section 1202 may also impact deal flow and structuring.

PE deal flow by year



Source: PitchBook

PE add-on activity by year



Source: PitchBook

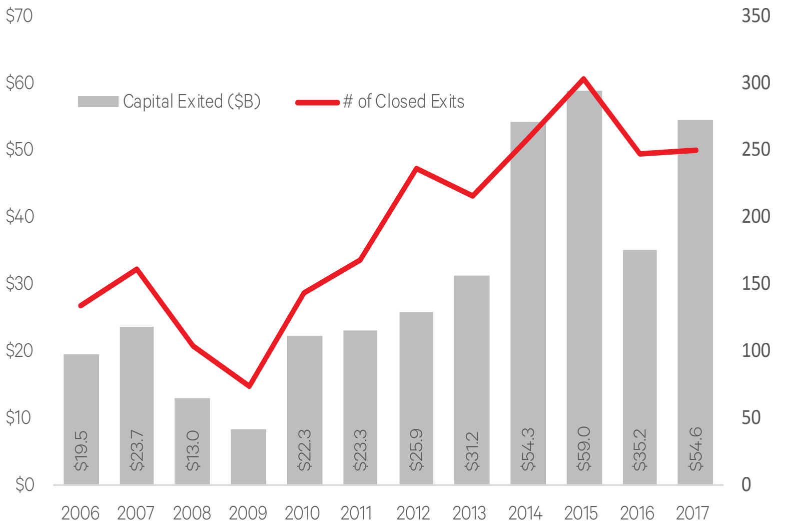
sub-$500M funds
Exit Flow

Exit activity was strong last year on a value basis. Almost $55 billion worth of capital was realized in 2017, a 55% increase over the $35.2 billion exited in 2016. Volume is trending down from its 2015 peak, however, with last year's 250 exits representing an 21% drop over two years. It should be noted, however, that many past years included large one-off quarters that somewhat skewed the annual totals. By contrast, 2017 was a consistently strong sellers' market, with the second and fourth quarters eclipsing the $15 billion mark in value.

2017 was a strong sellers' market, with the second and fourth quarters eclipsing $15 billion of exits each.

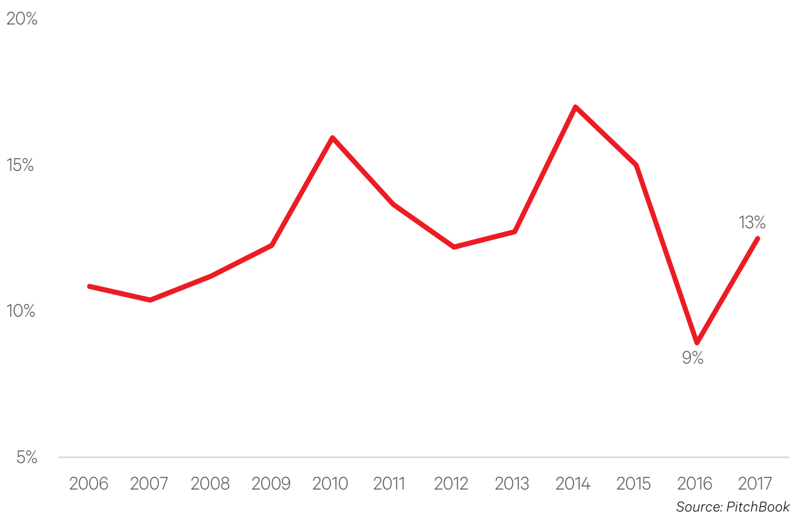
Strategics tend to be relatively less active at this end, which has an impact on the numbers. Companies with enterprise values of $100 million or less aren't likely to move the needle much for large public companies, so strategic competition is lighter and multiples lower for smaller companies. However, exit totals are buoyed by the strategics that do acquire PE-backed companies; if the target company does move the needle for strategics, they are less likely to be price-sensitive and will pay higher multiples to acquire them.

PE exit flow by year



Source: PitchBook

Capital exited as a percentage of total PE exits



Source: PitchBook

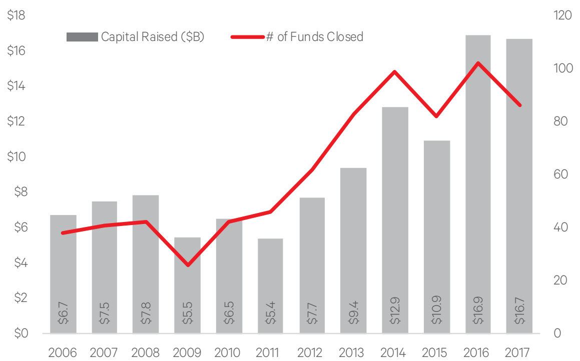
sub-$500M funds
Fundraising

Fundraising levels remain high in this part of the market, mirroring broader PE trends. About $16.7 billion was raised across 86 funds in 2017. Both figures were in line with 2016 totals, though the $16.9 billion raised in 2016 included more funds: 102 in total. In other words, funds that closed last year were bigger on average.

Most of 2017's totals were front-loaded, with Q1 and Q2 representing two of the three best quarterly totals since the financial crisis. Managers deployed the new capital quickly, with the second half of the year seeing an upswing in deal activity. That trend is expected in continue into 2018, assuming the domestic economy avoids a downturn.

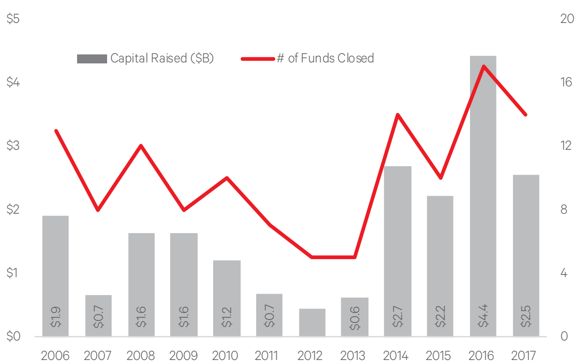
The fundraising trail has been welcoming to first-timers. Another 14 first-time buyout funds joined the fray last year, raising a total $2.5 billion in funds. Both figures were lower than 2016's record tallies: 17 first-time funds worth a combined $4.4 billion were raised that year. First-time funds tend to focus on specific sectors and companies within a certain size range. They also tend to perform relatively well, in relation to expectations and to the broader market. New firms, especially those in the lower middle market, often lack the resources that large, experienced firms have, and the funds themselves often include outsized contributions from the founders themselves. Both factors aid with motivation and, ultimately, with slightly higher returns.

Buyout fundraising by year



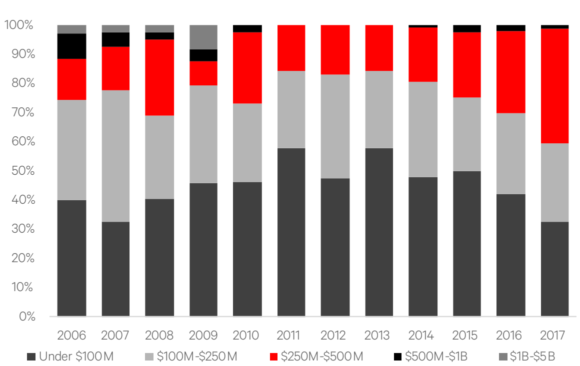
Source: PitchBook

Buyout first-time fundraising by year



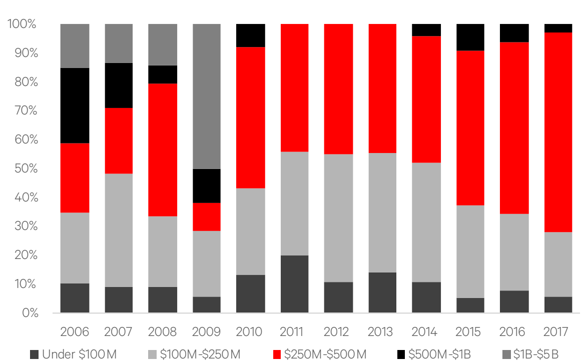
Source: PitchBook

Buyout fundraising by size (#)



Source: PitchBook

Buyout fundraising by size ($)



Source: PitchBook

More Cash, Less Tax

Section 1202 Tax Exemption and the 2017 Tax Act Make the Lower Middle Market Increasingly Attractive

By L. Frank Cordero, Esq.

A. Introduction and Summary

For private equity firms focused on lower-middle-market deals, Congress has made it a little easier to put more cash in partners' pockets even with ever-increasing purchase price multiples. The recent reduction of the federal corporate tax rate (down to 21%) and the tax exemption for eligible capital gains under Section 1202 of the Internal Revenue Code present significant incentives for lower-middle-market investments in C corporations. Although the gain exclusion does not increase reported pre-tax IRRs or cash on cash multiples, with a little planning, limited partners (and possibly the general partner) may be spared the 23.8% federal capital gains tax on qualified portfolio company dispositions.

Section 1202 of the Internal Revenue Code was originally enacted in 1993 and currently provides non corporate taxpayers with an exemption from federal income tax for eligible gains from the sale of stock of a qualified small business acquired after September 27, 2010. Subject to additional details below, the main points to consider when structuring an investment include the following:

- *$10 million/10 X Basis Gain Exemption per Investor and per Corporation*. The section 1202 tax exemption for qualifying capital gains generally is limited to the greater of $10 million per taxpayer ($5 million for married filing separately) or 10 times the taxpayer's original adjusted tax basis in the 1202 stock.[1] Each investor in a private equity fund classified as a partnership for tax purposes that sells shares of 1202 stock generally is entitled to a separate $10 million/10 times basis exemption with respect to each separate corporation that has issued 1202 stock sold by the private equity fund.[2] See sections B and C below.
- *5-Year Holding Period Requirement*. In order to qualify for the 1202 exemption, the stock sold must have been held for more than 5 years.[3]
- *C Corporation Requirement*. Only C corporations are eligible to issue 1202 stock. Equity in S corporations and other pass-thru entities does not qualify for the 1202 exemption.[4]
- *$50 Million Asset Limit*. Each corporation issuing 1202 stock must not have more than $50 million in aggregate gross assets (without deduction for liabilities) at all times before and immediately after the issuance of the 1202 stock,[5] and subsequent increases in corporate assets do not disqualify previously issued stock.

1 Code §§ 1202(b)(1)(A), 1202(b)(3)(A).
2 Code § 1202(g)(1).
3 Code § 1202(a)(1).
4 Code § 1202(c)(1).
5 Code § 1202(d)(1).

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- *Original Issuance Requirement*. The 1202 exemption only applies with respect to originally issued stock of the corporation, and stock purchased from a prior holder does not qualify for the exemption.[6] Certain gifts of 1202 stock and distributions of 1202 stock by partnerships to partners are permitted, but contributions of 1202 stock to partnerships terminate eligibility.[7]
- *Active Qualified Business Requirement*. At least 80% of the assets of a corporation issuing 1202 stock must consist of assets used in the active conduct of a qualified trade or business.[8] Certain types of businesses are not eligible, and additional restrictions on certain types of assets apply. See section E below.

6 Code § 1202(c)(1)(B).
7 Code § 1202(h).
8 Code §§ 1202(c), 1202(e).

- *Conversions into C Corporations*. Businesses organized as partnerships or disregarded entities can be converted into C corporations to qualify for the 1202 exemption, subject to satisfaction of all requirements. Subchapter S corporations generally cannot convert into C corporations and cause previously issued stock to qualify, but S corporations generally can contribute their assets to C corporations in exchange for stock that can qualify. See section F below.

B. Scope of the 1202 Exemption; Partnerships; Carried Interests

The 100% exclusion percentage under section 1202 applies to stock of a qualifying U.S. corporation acquired after September 27, 2010.[9] For stock acquired on or prior to this date, the percentage of the applicable gain which is excludable generally varies between 50% and 75%, depending on the acquisition date and other conditions.[10] The gain excluded pursuant to section 1202 is not subject to the 3.8% Medicare tax[11] and for 1202 stock acquired after September 27, 2010, is not subject to the alternative minimum tax.[12]

The sale of equity in a pass-thru entity is not eligible for the 1202 exemption, but qualifying gains earned by a pass-thru entity generally are allocated to the partners.[13] To be eligible for the exclusion, a partner must have been a partner in the partnership on the date on which the partnership acquired the 1202 stock and at all times thereafter before the disposition of the stock by the partnership.[14] The amount of gain that the partner can exclude from taxable income cannot exceed the amount of the gain exclusion determined by reference to the interest held by the partner in the partnership on the date the qualified small business stock was acquired.[15]

It is not clear how the 1202 exemption applies to gains allocable to a profits interest or carried interest[16] in a partnership, including a private equity fund. The statutory text might be interpreted to allow application of the 1202 exemption to the extent that the gain is attributable to a profits interest or carried interest that was issued and outstanding as of the issuance date of the 1202 stock, but it can also be interpreted differently. For example, regulations issued pursuant to Code section 1045 provide that in the case of 1202 stock rollovers, the amount of gain that can be deferred by a partner is limited by reference to the partner's lowest percentage of capital in the partnership at the time of issuance of the 1202 stock.[17] When these regulations were issued, the Treasury indicated that it was following the limits of section 1202. If this approach is also applied to gains allocated to a profits interest or carried interest, the 1202 exemption will not be available if the interest did not have any capital value at the time the 1202 stock was issued.

C. 10x Basis Limit

For purposes of the 10 times basis limit, the adjusted basis of any stock is determined without regard to any addition to basis after the date on which such stock was originally issued.[18] If capital contributions are to be made to an eligible corporation after the date of the original stock issuance, the contributing shareholder should consider making the subsequent contributions in exchange for additional shares of 1202 stock of the corporation, because additions to the basis of the original stock are not counted for purposes of applying the 10 times limit described above. If separate shares of 1202 stock are issued in connection with a subsequent contribution, the basis of the additional shares sold presumably should be taken into account for purposes of determining the 10 times limit.[19] For purposes of applying the 10 times limit to a partner in a partnership that disposes of 1202 stock, the partner is treated as having an adjusted basis in the 1202 stock equal to the partner's proportionate share of the partnership's adjusted basis in the 1202 stock,[20] and each eligible partner can separately apply the 1202 exemption up to the $10 million/10 times basis limit.

D. Issued for Money, Property or Services Requirement; Holding Period and Basis

To qualify as 1202 stock, stock generally must be issued by a corporation in exchange for money, property (not including stock of another corporation) or as compensation for services provided to the corporation (other than services performed as an underwriter of such stock).[21] When stock is issued in exchange for appreciated property, the 5-year holding period begins on the exchange date, and the 1202 exemption can apply only to gains that accrue after the transfer and does not apply to any built-in gain with respect to the contributed property.[22] The $50 million asset limitation and the 10 times basis limitation in such

9 Code § 1202(a)(4).
10 Code §§ 1202(a)(1)-(3).
11 See Code § 1411(c)(1)(A)(iii) and Regs. § 1.1411-4(d)(3), Example 3.
12 Code § 1202(a)(4)(C).
13 Code § 1202(g)(1)(B).
14 Code § 1202(g)(2)(B).
15 Code § 1202(g)(3).
16 A profits interest generally is an interest in a partnership that does not have a liquidation value upon issuance and otherwise complies with Rev.Proc. 93-27 and Rev. Proc. 2001-43. Carried interests issued by private equity funds are generally structured to comply with these rules.
17 Regs. § 1.1045-1(d).
18 Code § 1202(b)(1).
19 No authorities specifically address whether tax basis of subsequently issued shares should be ignored if said basis is attributable to a subsequent contribution by a shareholder or shareholder group that owns 100% of the corporation's stock before and after the issuance. Such a contribution and stock issuance does not appear to contradict the purpose of the statute and the restriction on subsequent basis increases.
20 Code § 1202(g)(1)(B).
21 Code § 1202(c).
22 Code § 1202(i).

cases would be based on the higher value of the appreciated property and not its adjusted basis for other tax purposes.

E. Active Business Requirement; Ineligible Businesses; Eligible Businesses

In order to qualify for the 1202 exemption, during substantially all of the taxpayer's holding period of the stock, the issuing corporation generally must meet applicable active business requirements.[23] This requires that at least 80% of the corporation's assets (determined by value) be used in the active conduct of 1 or more qualified trades or businesses.[24] A qualified trade or business means any trade or business other than the following prohibited businesses:[25]

- any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees;
- any banking, insurance, financing, leasing, investing, or similar business;
- any farming business (including the business of raising or harvesting trees);
- any business involving production or extraction activities which qualify for certain depletion deductions, such as mining and oil and gas activities; and
- any business of operating a hotel, motel, restaurant, or similar business.[26]

Authorities interpreting the scope of ineligible businesses are limited. In a 2012 memorandum decision, the Tax Court found that the active business requirement was satisfied where the corporation's principal asset was the training and organizational structure of a business with about 150 employees and 350 independent sales agents.[27] Two private rulings issued by the IRS in 2014 and 2017 indicate that the IRS does not consider a business to be an ineligible healthcare business if it does not involve the performance of services for patients directly and is limited to either the performance of research and development and similar services for a drug manufacturer[28] or the performance of laboratory tests requested by physicians.[29] The foregoing are helpful for purposes of interpreting limitations on section 1202, but private rulings do not bind the IRS with respect to other taxpayers and are not legal precedents.

Section 1202 also provides special rules that can disqualify a business if it has excessive stock, securities or real estate. The active conduct of a qualified trade or business requirement will not be satisfied if either of the following conditions applies:

- more than 10% of the value of the corporation's assets (in excess of liabilities) consists of stock or securities in other corporations if the corporation does not own more than 50% of the stock of such other corporations, by vote or value (except that assets held for working capital purposes generally are not prohibited, subject to compliance with additional rules);[30] or
- more than 10% of the value of the corporation's assets (without deduction for liabilities) consists of real property which is not used in the active conduct of a qualified trade or business (and dealing in or renting real property is not an active qualified trade or business for this purpose).[31]

Regardless of the foregoing, rights to computer software that produce certain active business computer software royalties and satisfy certain detailed rules are treated as assets used in the active conduct of a trade or business.[32] Subject to satisfaction of applicable requirements, examples of active businesses that might qualify under section 1202 include manufacturing, distribution and sale of goods (including pharmaceuticals); medical testing; transportation and logistics; telecommunications; media; and active software development.[33]

Any business that satisfies the requirements described above should be eligible under section 1202 if other applicable requirements are satisfied. Businesses should review their operations and consult with their tax advisers to determine if they are eligible under section 1202.

F. Conversions into C Corporations

If a business is initially operated as a partnership or disregarded entity, conversion of the entity to a C corporation structure generally can be achieved on a tax-free basis under Code section 351,[34] either by means of an actual contribution of the entity's equity interests or its assets to a newly formed corporation, or by filing of a check-the-box election to classify the entity as a corporation for federal tax purposes. If applicable requirements

23 Code § 1202(c)(2)(A).
24 Code § 1202(e)(1)(A).
25 Code § 1202(e)(3).
26 Code §§ 1202(e)(3)(A)-(E).
27 Owen v. Comr., T.C. Memo 2012-21.
28 PLR 201436001.
29 PLR 201717010.
30 Code §§ 1202(e)(5)(B), (5)(C) and (6).
31 Code § 1202(e)(7).
32 Code §§ 1202(e)(8), 543(d).
33 Code § 1202(e)(8), 543(d).
34 The incorporation is subject to tax if liabilities exceed tax basis pursuant to Code § 357.

are satisfied, appreciation in the value of the stock of the corporation accruing after the conversion date would be eligible for the 1202 exemption. The stock would need to be held for more than 5 years after the conversion date. The pre-conversion appreciation in the assets of the business would not be eligible for the 1202 exemption, would be taken into account for purposes of determining if the $50 million asset limit has been exceeded, and also would be taken into account for purposes of the 10 times basis limit.

Outstanding stock of an S corporation does not become eligible for 1202 status by terminating the S election and conversion of the corporation into a C corporation. Benefits under section 1202 can, however, become available to existing shareholders of an S corporation if the S corporation contributes money or property (but not stock) to a newly formed C corporation that is owned by the S corporation. The contribution of assets to a subsidiary corporation would be subject to the discussion in the preceding paragraph, and the rules relating to 1202 stock held through pass-thru entities would apply thereafter.

G. Other Factors in Entity Choice Decisions

The 1202 exemption and new 21% federal corporate tax rate are factors favoring the use of a C corporation to conduct a qualifying business. Nevertheless, pass-thru entities also have their own advantages, and all factors should be taken into account when choosing the form of organization.

H. Conclusion

The 1202 exemption provides investors with an opportunity to save substantial amounts of tax and free up cash that can be used to make additional investments in private equity funds. When combined with the new 21% federal corporate tax rate, C corporation investments in qualifying lower-middle-market businesses seem more attractive than ever. Eligible businesses include manufacturing, distribution and sale of goods (including pharmaceuticals); medical testing; transportation and logistics; telecommunications; media; active software development; and other businesses that satisfy applicable requirements. Tax incentives alone may not be reason enough to start a foray into eligible industries, but investors participating in these industries may find some low-hanging fruit in the 1202 exemption and some careful planning.

I. Additional Details and Information

This discussion is only a summary of the 1202 exemption, and additional conditions and details may apply to individual situations. Additional information regarding the exemption and factors that are relevant to choice of entity decisions is set forth in L. Frank Cordero, *Old Dogs and New Tricks: Section 1202, New Tax Rules and Entity Choice*, 59 Tax Mgmt. Mem. (BNA) No. 5, 63 (March 5, 2018), reproduced on Akerman's website.

L. Frank Cordero is a tax lawyer and partner at Akerman LLP's Miami office, and Chair of the firm's Federal Tax Practice Group. Special thanks to Akerman corporate partners David Birke, Paul Quinn and Carl Roston for their input.

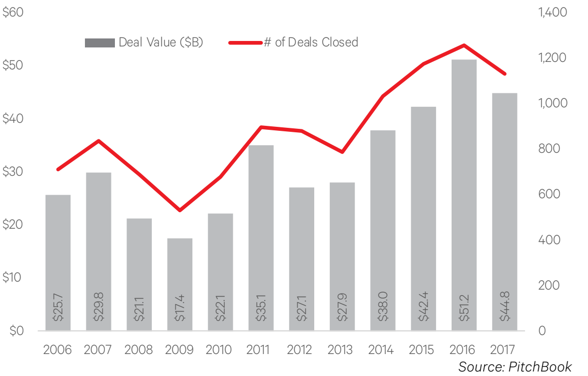
sub-$1B funds
Deal Flow

Deal activity at the higher end of this market (funds between $500M and $1B) saw a slight decline last year. 1,133 transactions were completed, worth a combined $44.8 billion, with both figures below 2016 totals (1,258 deals worth $51.2 billion). Even so, activity remains high compared to years past. The trend toward deals of this size began in earnest four years ago. For context, 2013 levels were 43% lower by count and 60% lower by dollars invested.

In this sector of the market, the “buy-and-build” approach has been relatively less active than in the sub-$500M range. Add-on value—that is, the total amount spent for all add-on transactions—has declined recently. After sponsoring $12.2 billion worth of add-ons in 2015, PE firms spent $9.1 billion and $7.8 billion in 2016 and 2017, respectively. Over the past two years, in other words, total add-on value has dipped 36%. While the dollar value is down, counts are healthy: Each of the past three years has seen at least 630 add-ons, nearly twice the amount recorded in 2010.

Valuations remain challenging. On a median basis, investors paid 7.6x for transactions last year, down slightly from the 8.4x median seen in 2016. A willing and able debt market continues to show in the numbers, with debt contribution of 4.1x in 2017; each of the past five years recorded debt/EBITDA multiples of 4x or higher. Expected interest rate hikes this year may have relatively minor effects on purchase price multiples and deal flow going forward. Activity may also be impacted by recent changes to the tax law. While there is now a disallowance of certain interest expense deductions at certain levels, the decline in the corporate tax rate (from 35% to 21%) may provide a tailwind for investors.

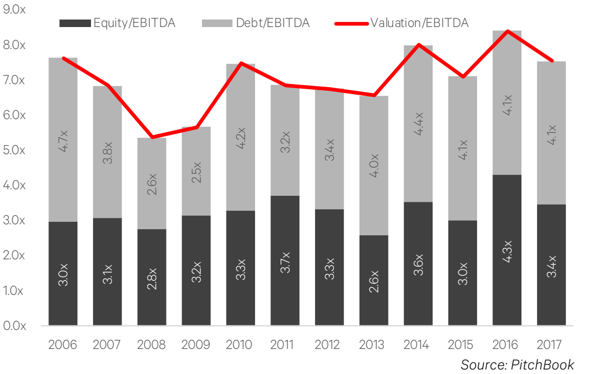
PE deal flow by year



Source: PitchBook

While there is now a disallowance of interest expense deductions at certain levels, the decline in the corporate tax rate may provide a tailwind for private equity: Both PE funds and their portfolio companies qualify for the corporate tax reduction that went into effect January 1.

M&A multiples by year (<$200M)



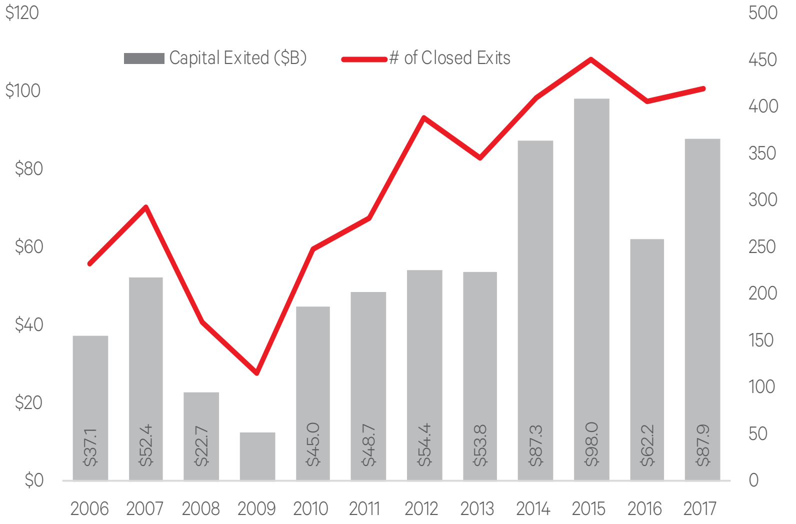
Source: PitchBook

sub-$1B funds Exit Flow

Exit activity for sub-$1B funds hit an all-time record last year. Almost $88 billion of investment was exited in 2017, a 41% increase over 2016 levels while approaching 2015's record of $98 billion in total exit value. The last three quarters were consistently strong, notching at least $19 billion worth of exits apiece. The highest single quarter in 2016 was $18.9 billion.

Strategic acquisitions are more common toward the higher end of the market. PE funds that approach the $1 billion threshold are likely to find corporate buyers willing to pay higher multiples. Moreover, research from Bain & Company indicates that corporate acquirers are enjoying, on average, 39% higher shareholder returns after making 12 or more acquisitions in today's low-growth environment. That bodes well for PE-to-strategic exit activity going forward. That said, secondary buyouts (SBOs)—in which a PE-backed company is sold to another PE fund—will likely remain a very strong exit route in the near-term, notwithstanding price sensitivities. PE funds looking to offload portfolio companies are welcomed, with strong interest, by fellow financial sponsors looking to put their capital to work. Expect overall exit activity to remain healthy as long as both exit ramps remain open.

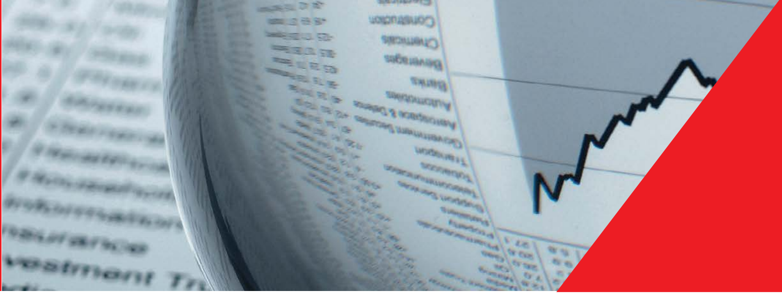
PE exit flow by year



Source: PitchBook

Capital exited as a percentage of total PE exits

Source: PitchBook



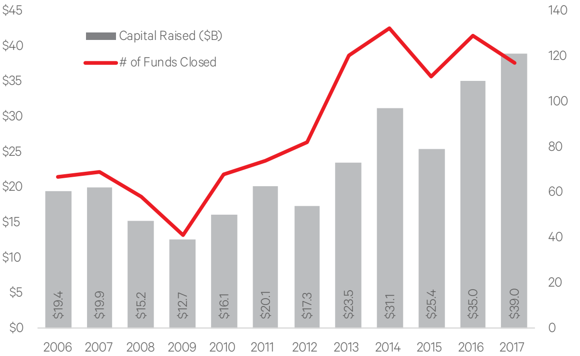
sub-$1B funds Fundraising

Like other markets, PE fundraising in the $500M-$1B range hit a new high in 2017. The $39 billion raised last year was a record, eclipsing the $35 billion raised the year prior. Fund counts remain historically high as well, with 117 new vehicles closing in 2017. PE funds on the whole are enjoying positive returns and those with impressive returns are not having much difficulty re-raising in this environment.

PE firms are benefiting from a reverse-denominator effect impacting their limited partners (LPs); returns from equities and fixed income have distorted allocations among asset managers most likely to have significant PE exposure. In order to maintain their allocation targets, LPs are massively reinvesting in private equity, especially in larger funds. LPs have sought in recent years to consolidate their PE commitments around fewer, more-established PE funds. The benefits of doing so include access to larger co-investment opportunities and reduced due diligence costs from fewer fund commitments.

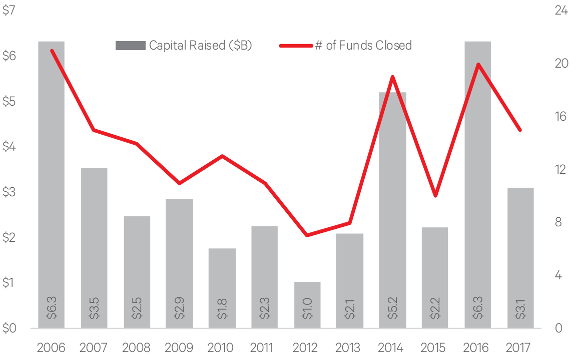
Today's torrid fundraising market is expected to continue into 2018, assuming the economy remains healthy, though as distributions back to LPs begin to moderate, so too will this historic fundraising opportunity.

Buyout fundraising by year



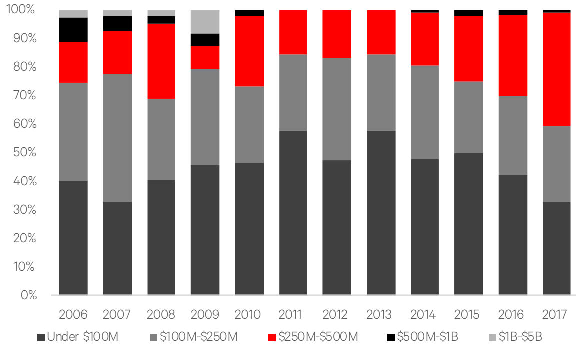
Source: PitchBook

Buyout first-time fundraising by year



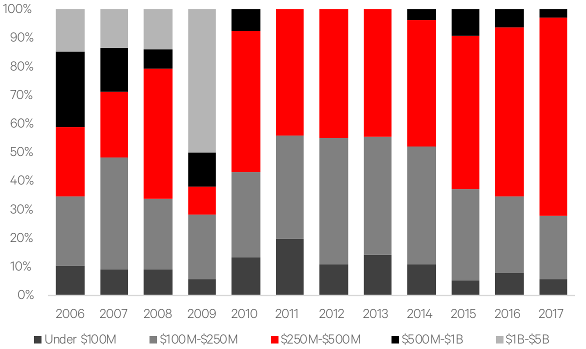
Source: PitchBook

Buyout fundraising by size (#)



Source: PitchBook

Buyout fundraising by size ($)



Source: PitchBook

Private Equity Spotlight

With Palash Pandya, Co-Deputy Chair, Corporate Practice Group and Paul Quinn, Partner

We are quite optimistic about the relative performance of funds at this end of the market vis-à-vis global private markets in general. Among the reasons for optimism are that purchase price multiples for companies in this end of the market continue to be lower than for larger deals and the public markets, providing an opportunity for multiple expansion for portfolio companies through successful growth organically and through acquisitions. Also, compared to other segments of the global private markets of this size, domestic buyouts tend to have a very favorable return profile over cycles. And while the perception is that assets under management in this sector of the market has grown so much that competition for deals will depress returns, we believe that the concern may be somewhat overstated on a relative basis because, as compared to the market capitalization of the Russell 2000, it has not really increased. And as purchase price multiples actually declined in 2017 compared to 2016, we believe that this discipline bodes well for future returns.

Your team at Akerman deals primarily with PE funds with $1B or less, as opposed to much larger funds that get more attention and influence our understanding of the industry. How does the sub-$1B market differ from the larger end, and why is that such an important difference?

Paul: One of the things that sets these funds apart is that they tend to have less internal resources than the largest of funds. As a consequence, they tend to rely more on outside counsel and therefore our clients in this sector of the market require exceptional responsiveness, continuity of staffing and a "higher touch" to effectively support them. And part of this "higher touch" requires better continuity of sophisticated staffing across the deal team to more effectively and efficiently close deals while mitigating risk in a manner consistent with their particular way of doing business. Our clients tell us that success in this sector of the market requires being trusted advisors with business acumen as well as legal technicians.

Palash: In terms of sourcing, their business development teams may not be as large as at the largest of funds. So the sourcing is different, and we work with our clients by holding events and making introductions for them to source deals and meet others in the industry. Akerman hosts a series of Deal Bridge events, at which we host dozens of private equity and investment banking professionals for brief, rotating, one-on-one meetings and other relationship-building activities designed to facilitate investment opportunities. The feedback for our Deal Bridge events has been overwhelmingly positive as far as their value in deal sourcing. The impetus for Deal Bridge was listening to our clients about their goals and objectives and trying to find ways beyond being lawyers to help our clients accomplish them.

Paul: As lawyers advising on these transactions, we need to be very efficient because the transaction costs need to be in line with the size of the transactions. We recognize that it is imperative to have continuity of staffing, to scope diligence processes with clients to avoid unnecessary duplication of effort and to build lean and nimble deal teams.

Sub-$1B funds are starting to mimic larger funds and even strategics in some cases. In what ways?

Paul: Funds in this sector are increasingly implementing strategies to improve their ability to source and evaluate potential acquisition targets and then support the management teams in growing portfolio companies. As is the case with many of the largest funds and strategics, many of these funds are increasingly specializing in one or more industries or sectors and developing information and analytics advantages by hiring operating and executive partners

Palash I. Pandya, Co-Deputy Chair, Corporate Practice Group

Palash Pandya provides strategic advice to public and private companies in a variety of transactional, securities, and general corporate matters.

E. Paul Quinn, Partner

Paul Quinn represents private equity funds and their portfolio companies in leveraged acquisitions and dispositions, corporate governance, and restructurings.

and aligning themselves with executives and advisors with a history of success within these targeted industries or sectors. We have been impressed by the extent to which many of our clients are able to get to know target management teams before they come to market and to obtain fireside chats, so as to better understand the prospects, management team and valuation of a target and make smarter investment decisions. Likewise, we have been impressed by the extent to which a number of these funds have become the successful bidder by developing a reputation for supporting the growth and development of the management teams of their portfolio companies and the success of their portfolio companies; and in this sector of the market, factors other than valuation more frequently impact which bidder is ultimately the buyer. In years to come, those funds that leverage these resources to make smarter investment decisions, and develop reputations for knowing an industry so well that they close deals consistently on the terms set forth in Letters of Intent and then support their management teams in successfully growing portfolio companies, will increasingly have advantages over competitors.

Palash: Agreed; and through these relationships, they're obtaining deep industry expertise and an information advantage in determining which verticals to target and which companies to buy. Their operating and executive partners also are helping with due diligence, assisting with hiring advisors and consultants who also have that background, wooing management teams and supporting the overall success of portfolio companies.

Clients in this sector more often buy their portfolio companies straight from their founders or their families, as opposed to strategic or financial sellers. How are the two processes different, and what do advisors need to understand when their clients buy companies from their founders?

Paul: We are involved in such a high volume of work on both sides of the table in founder/family-owned sales that we understand how to creatively solve for challenges that may be more prevalent in this sector of the market. We understand that there may be factors aside from valuation, such as certainty to close and risk allocation, that are critically important to founder/family sellers, and there is often emotion and an element of seller's remorse that requires a milder yet perseverant bedside manner. One needs to be more sensitive to the dynamics with respect to the seller's mindset; for example, a founder/family seller can get quickly frightened by aggressive posturing, an approach which might work with a sophisticated seller who views it as just another business tactic. It's a bit of an art. We also understand in these circumstances the need to creatively address non-market impediments to closing in a way that meets the needs of the parties while effectively managing key risks. We also are acutely aware of the variation in sophistication and temperament of opposing counsel in these transactions and the need to evaluate and effectively work with them—which sometimes requires a more patient and collaborative approach that enables them to get to yes.

Palash: And, not infrequently, when one is representing a fund that's buying from a non-institutional seller, the business is not totally buttoned up and ready for a sale process. So, it's often not going to be a streamlined process and due diligence may be even more important—not because the target intentionally isn't disclosing information, but more likely because that information sometimes isn't easily understood. We also recognize the need to handicap for our clients the magnitude and probability of risk based on empirical claims data within an industry and to focus relatively more attention only on those areas.

Please touch on representations and warranties insurance and its increasingly prominent role in today's dealmaking environment.

Paul: In this sector of the market, it's become commonplace to see representation and warranty insurance. Most bidders recognize that in most circumstances in order to be competitive they must purchase a policy that shifts post-closing risk from the seller to the insurer. Sometimes the buyer pays the premiums on that policy; sometimes the premiums are split. These policies have changed over the years (in large part due to the competitive environment); changes which have been improvements for the purchasers of this type of insurance. The premiums have gone down, the retention percentages have gone down, and the coverages themselves have increased in scope. Fundamental representations and warranties that were not covered in the past are now covered today. Beyond those fundamentals, taxes (not the known tax amount, but the unknown amount) and regulatory items such as healthcare and government contracts are also increasingly insurable. There's much more coverage and more insurers in the market today, and that means that the negotiation of the purchase agreement ought to be somewhat easier. There is less negotiation over individual representations and warranties and indemnity sections of the agreement than in the past, because those new policies are stepping in to support those sections of the purchase agreement. And, for a number of our clients who were early adopters of representation and warranty insurance, it has been a competitive advantage as sellers' post-closing exposure is quite limited. It's a brand-new area of the practice over the last few years that corporate dealmakers have had to get up to speed on, whether they liked it or not, because it's become so prevalent. What is often a key negotiating point is the extent to which a buyer is successful in negotiating for the seller to be liable for claims for breaches of representations and warranties that are not covered by the policy or that exceed the policy limits. In this regard, buyers need to be comfortable with the level of coverage they purchase.

Palash: And this insurance is only one of a number of tactics that originated in larger and public deals that are now creeping into this sector of the market for bidders to be more attractive. Some bidders are eliminating working capital adjustments and others are agreeing to virtually no survival of any obligations of the sellers after closing other than post-closing restrictive and other covenants, "bad-boy" provisions and other limited and tailored terms.

Do you think this current trend is a new normal?

Palash: In this part of the market, absolutely.