# Future investments

**Andrew Hulsh**
hulsha@pepperlaw.com

**James B. Jumper**
jumperj@pepperlaw.com

## Andrew Hulsh and James Jumper of Pepper Hamilton explain why it's taking longer for GPs to source and negotiate new transactions, and what they can do to mitigate this challenge.

One of the more notable findings in our survey is that more than half (56%) of PE houses report that the length of time spent tracking and investigating potential investment targets has increased over the past five years, with more than a quarter (28%) saying it has increased "significantly."

The simple fact is that the US PE industry is fiercely competitive. The supply/demand imbalance between capital chasing a home and available transactions is such that we are in the highest multiple environment in the industry's history.

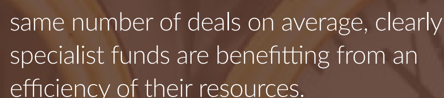
This is forcing GPs to change their dealmaking considerations and behavior. Due diligence has never delved deeper. Funds must drill down on assets to ensure high prices can be justified, whether it be through operational improvements to the business, creating synergies, mapping potential roll-out strategies or reengineering capital structures.

They are also having to use their smarts to avoid paying hefty multiples. One strategy is to look beyond typical investment bank-led auctions to source proprietary buyouts. We are seeing our clients taking the efficacy of contact management systems more seriously than ever before and being proactive with service provider relationships — whether it be investment banks, accounting firms, law firms or deal executives — to bring more deals through the pipeline.

Another solution to overcoming saturated market conditions has been to reach into niches and pockets where others aren't looking. Some are forming strategic alliances with industrial partners to tap expertise and access assets that would otherwise fall under the radar.

Expertise is more than just a buzzword. Those funds with highly developed networks and who can bring industry mavens into portfolio company board seats are at a significant advantage in today's pricing environment. Capital is capital. Management teams will be won over by those funds who have the credentials to truly transform companies and bring added value by leveraging their sector expertise.

Specialization is a theme we expect to see continue. It is estimated that generalist funds consider as many as 80 potential transactions before deciding on a deal. By contrast, specialist funds typically see approximately 20 investment and acquisition opportunities before settling on one. If both are concluding the



same number of deals on average, clearly specialist funds are benefitting from an efficiency of their resources.

Such strategies also present a value-creation play. GPs that own a number of companies within a given sector, or verticals within the same industry, are able to eke out extra margins by synergizing operating costs. For example, one of our GP clients investing in a sector that is heavily dependent on manufacturing has outsourced all of its portfolio companies' production to another business in the fund with ample capacity to service their demands. Typically, strategic buyers are able to outbid PE houses on deals by paying a synergistic premium. However, managers who are able to daisy-chain their portfolio companies can justify meeting today's high multiples by implementing significant cost savings post-transaction.

While the leveraged buyout will always remain PE's deal structure of choice, we are also seeing the rise of minority investments as a means to create portfolio diversity and balance upside while limiting capital risk exposure. This requires a slightly different approach.

Since funds forego control in minority investments, it is necessary to conduct additional due diligence on the management teams in such situations. Any issues must be identified early and addressed prior to closing the transaction.

We have been helping our PE clients resolve the concerns they have over buying non-controlling stakes, by building economic rights into deal documentation. Redemptions, put-right mechanisms and drag-along rights enable GPs to control their exits—a critical aspect of every PE sponsor-backed transaction—if a liquidity event does not occur within their desired investment horizon. This may involve time-based provisions, milestones based on earnings or other metrics, or default protections. In the case of a "put"-type option, if the portfolio company does not meet the agreed conditions, the fund would have the right to sell its shares back to the company for a pre-negotiated price.

Some of our clients have expressed concern that these rights are academic. If the company doesn't have the capital to repurchase the shares, our clients fear being locked in and unable to liquidate their investment. In some instances, we have included springing board rights into transactions that allow the GP to take additional board seats if milestones are not met or covenants are breached, allowing them to force a sale and realize a return for their investors. While this may be an extreme measure, it underscores how private equity dealmaking is evolving to keep up with the times.

We are in one of the most challenging deal environments of any business cycle and, short of a major sustained macroeconomic shock, substantial multiples are likely here to stay. This, in turn, is lengthening the time GPs spend seeking out deals that match their risk-return profiles. It is the most creative managers who can think outside the buyout box that will surpass their peers in these conditions.