Breaking Down PE's Push into the Lower Middle Market

1Q 2019

A Review of Key Dynamics in the Lower Middle Market

Data provided by: PitchBook

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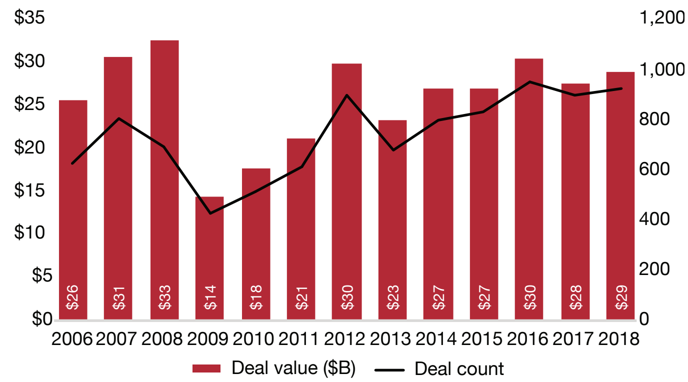
As alternative investments in general have grown in allure throughout the past decade, private equity (PE) has become a highly attractive strategy, leading to multiple years of strong fundraising. Consequently, fund managers of all kinds have faced an increasingly competitive marketplace, with plenty of capital vying for the best-quality assets. This heightened activity has contributed to a surge in activity within the US middle market (MM)—its lower environs in particular. No meteoric rise has been observed, but the consistency of deal flow within the classic lower middle market (LMM) (transactions sized between $25 million and $100 million) has been remarkable, with the past three years notching nearly or well over 900 transactions per year for close to or exceeding $30 billion a piece.

A surge of activity within the US lower middle market has occurred.

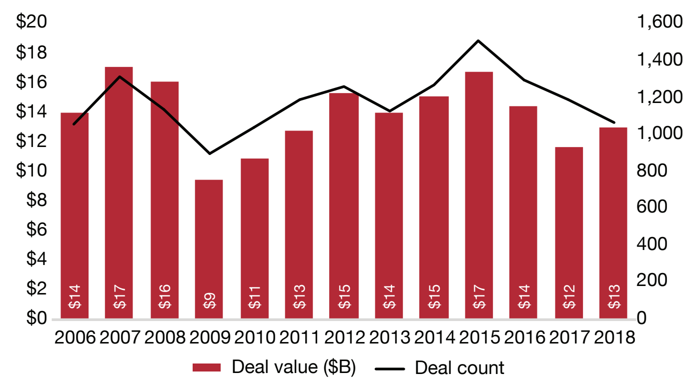
Segmenting the LMM further, however, does yield the insight that pricing pressures have begun to take a toll on volume within the sub-$50 million space, likely because competition has pushed a portion of those transactions beyond the $50 million size marker. The data somewhat bears this out, as the $19 million median deal size in the sub-$50 million space in 2018 was the highest tally ever recorded within the US. However, the steadiness in the same metric for the traditional LMM is intriguing; it suggests that competitive pressures are limited to some extent within these market ranges, as ultimately the bulk of transactions align around the $50 million to $55 million bounds in size.

PE activity in US LMM*



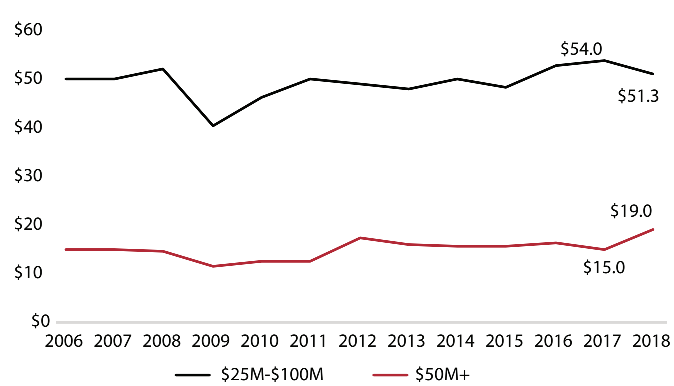
Source: PitchBook

PE activity in US LMM sub-segment*



Source: PitchBook

Median US PE deal size ($M) by market segment



Source: PitchBook

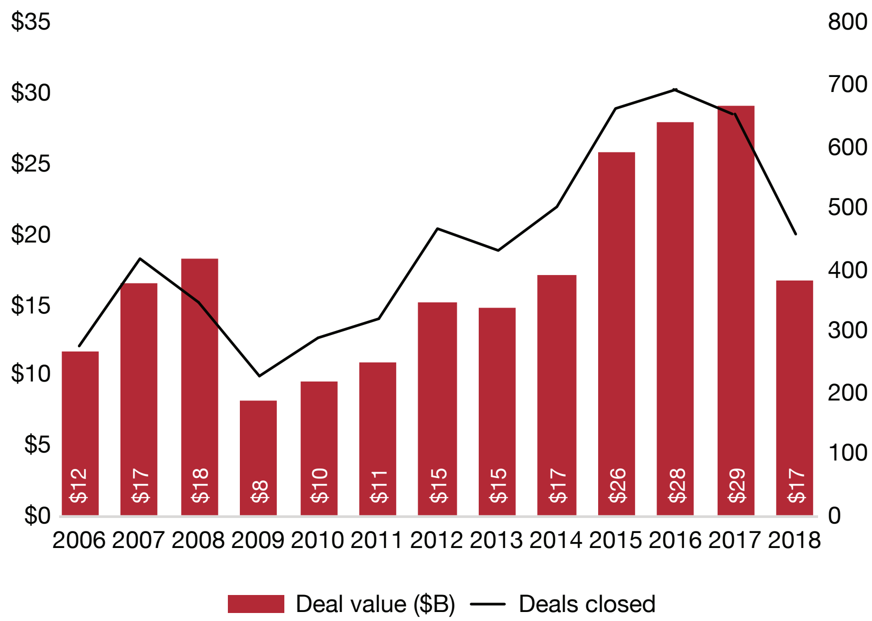
*Note: Within this review, the LMM is defined as transactions sized between $25 million and $100 million, while the sub-segment is defined as transactions of $50 million and below.

As a strategy, add-ons have become increasingly popular in the past half-decade in the broader market. Although they combine the appealing features of justification for higher entry purchase price multiples for platforms as well as consolidation, they do require additional legwork and a well-defined strategy centered around consolidation and integration. Those requirements, more than anything else, are likely contributing to the sudden decline in add-ons within the LMM after a record aggregate deal value in 2017. Plus, given that the decline in volume just barely lagged a stretch of massive aggregate deal values exceeding $20 billion for three years straight, it is likely the cycle was affected by inflation in median deal sizes as well, even for the specific add-on strategy.

After cresting at over 1,100 transactions in 2015, volume has declined slowly, though remains robust.

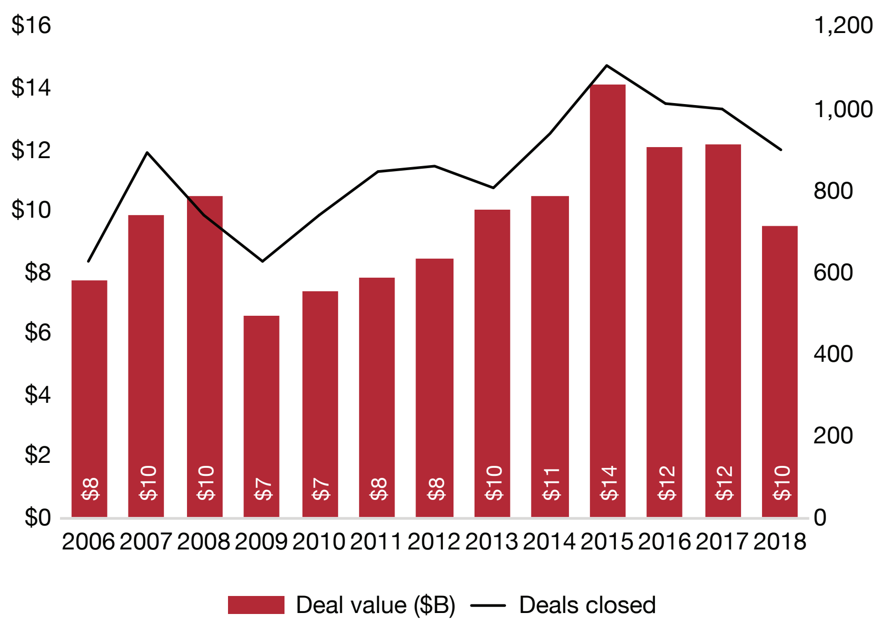
Fascinatingly, that pressure was exerted even within the smaller, sub-$50 million segment. After cresting at over 1,100 transactions in 2015, volume has declined slowly, although it must be admitted that levels are still robust compared to historical tallies. It is difficult to assess whether supply and demand dynamics are contributing to the impact; not all sectors are as prone to fragmentation as, say, healthcare services, so there isn't an endless supply of worthwhile targets for PE firms to pursue within the LMM. Rather, demand and pricing pressures are likely conjoined factors driving activity down. It doesn't make economic sense for some PE firms to pursue a plethora of targets at that size range; and for those that are in play, if median deal sizes have hit an all-time high, it may discourage closing transactions at as fast a clip as in the past.

Add-on activity in US LMM



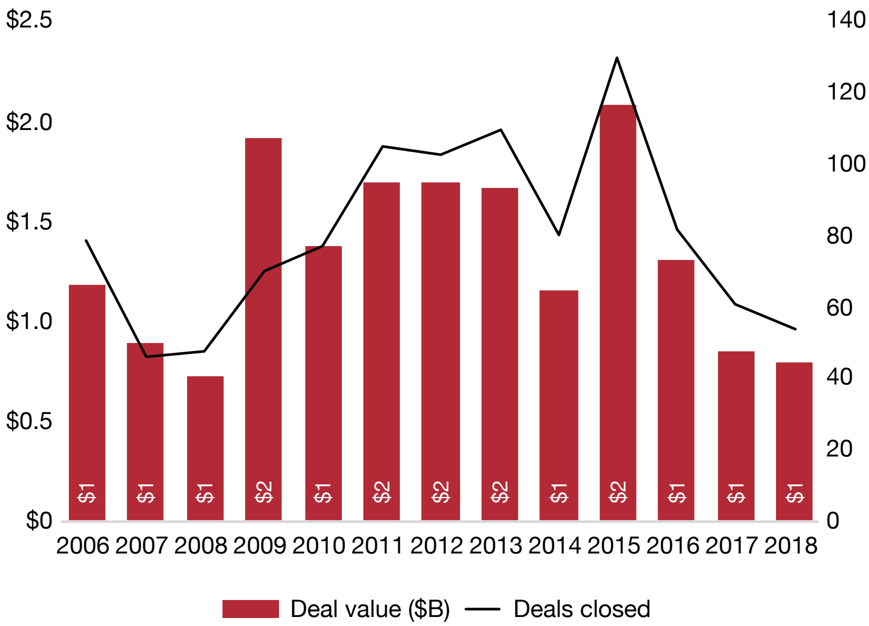
Source: PitchBook

Add-on activity in US LMM sub-segment



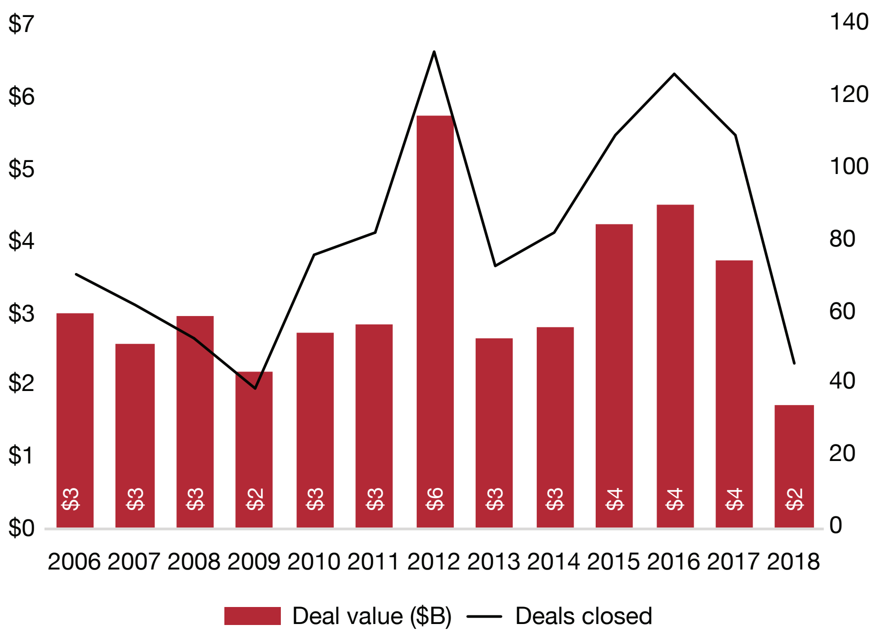
Source: PitchBook

SBO activity in US LMM sub-segment



Source: PitchBook

SBO activity in US LMM



Source: PitchBook

However, the diminution of add-ons pales in comparison to the plunge in closed secondary buyouts (SBOs) within the LMM. Granted, that is in the wake of a sharp peak, but herein, this particular strategy falls under the category of opportunism more than others. Especially at this scale, the incentives for purchasing a fellow PE firm's portfolio company must align well, i.e. there must still exist either opportunities for sufficient scaling up or perhaps additional operational improvements to be made. That said, that still doesn't ensure such sponsor-to-sponsor transactions will be concluded. The macro environment as well as financing structures must check out, because typically one is acquiring a company that is already working through a capital structure laden with a debt package that must be taken into account.

Both SBO volume and value in the sub-LMM have nosedived since 2015.

SBO activity within the smaller sub-segment of the LMM further reinforces this finding, as both volume and value have nosedived since a peak in 2015. It should be noted that circumstances in 2015 were more conducive overall to SBOs, as the financing environment was as lax as ever and yet pricing pressures had not materialized to the extent that they have today. It is too far to presume that supply dynamics were more favorable at that time, beyond the potential impacts of generational small business transfers and macroeconomic cyclical woes finally taking their toll post-financial crisis. One last factor definitely contributed: The increase in median deal sizes may also have eventually pushed at least some SBOs beyond the $50 million threshold, albeit not many.

Q+A

President and CEO Tim Clifford with COO Sean McKeever on dealmaking, credit trends and more

Why has the LMM in the US become more attractive to US PE investors as of late?

First, we should define what Abacus considers to be LMM. We think of it as a company that has $3 million to $15 million in EBITDA or $10 million to $100 million in revenue. This segment continues to grow and has more companies available for M&A than either the MM or upper middle market (UMM). Just the absolute size of the market with more than 175,000 businesses coupled with it being significantly event-driven (founder retiring or having health issues, succession planning, liquidity needs, etc.) continues to drive deal volume.

Though there is competition for all buyouts, especially larger ones, there is less competition in the LMM. It's still a less-efficient market, which translates into attractive returns.

Often times this is the first institutional capital into the company, and there are many opportunities for the sponsor to professionalize the business (invest in the sales organization, improve processes and operations, update systems, etc.).

Also, in the LMM, it's more attractive (and less expensive) to pursue a buy-and-build strategy. Smaller, less expensive add-on acquisitions can create a sizable platform with synergies and multiple expansion, which has a meaningful impact on returns for the PE investor.

What are the key differentiators and factors for lenders active within the US LMM as opposed to other market segments?

Lenders in this market are much more driven by relationships than in larger markets. It helps for the sponsor to know that a lender has extensive experience with smaller companies, understands there can be some uneven performance, and will not panic if there is a bad quarter. Relationships really do matter here; the most successful lenders understand and act that way. Those that have more of a transactional perspective tend to not gain long-term traction.

We also see that compared to larger market segments, each deal has its own nuances. In our experience, most PE firms want a lender that is flexible and can create tailored solutions—which is what Abacus brings to the table.

Unitranche has risen in popularity—what is your take on that and other debt types' utility in the current environment, and what makes the most sense for LMM companies involved in transactions?

There is a lot of interest in unitranche given the perceived ease of use on the front end, but depending upon the source of the capital, should a default occur, negotiations can get complicated between the first-in and last-out lenders or a back-end leveraged facility. That's when the sponsor will find out with whom it is really negotiating. These structures are less flexible when a problem occurs. Our "classic senior" execution with a slice of third-party mezz is a tried and tested solution. Given the rising-rate environment, it makes sense to have a portion of your capital structure with fixed-rate debt. Also, during a difficult situation, there is flexibility for mezz interest to be blocked which often can't be done with a unitranche facility.

With a senior/mezz structure, you will also have more dry powder to pursue the add-on strategy.

Given broader market conditions, what are the items that LMM companies looking for financing should prioritize?

They should look for four attributes. One, look for lenders that have expertise with smaller buyout financing. Two, will they be flexible and easy to work with? Three, will they close on time and with reasonable expenses? And four, is the cost of capital reasonable? Our goal at Abacus is "making life easy" for the PE sponsor. We want to show our clients that we deliver on all four measures and that we would be a true partner for the long term.

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Per PitchBook data, 2017 saw a record sum of add-on deal value in the US LMM, although 2018 saw a falloff; what is your take on the add-on strategy in the current market, heading into 2019?

Add-ons remain a critical component of value creation in the LMM—particularly as valuations for platform companies remain at historic highs. It continues to be an attractive strategy to average downward on purchase price valuations. We see more and more of our sponsors looking at add-ons, consolidating sectors and rolling up certain industries. In 2019, the strategy will continue, and we do not believe the drop from 2017-2018 is a trend. The robust add-on activity seen in 2017 may have contributed to the decline in 2018 as sponsors and platform companies were busy working on integrating all the add-ons closed in 2017 and at the end of 2016.

How does the popularity of the add-on strategy affect your collaboration with target companies in the LMM and PE firms looking to build out platforms therein?

Without a doubt, an add-on has the potential to meaningfully strengthen our partnership with the PE firm as we collaborate to structure and finance the transaction. Add-ons typically have tight timeframes and require collaboration with all participants rowing in the same direction. When we help provide a smooth and efficient execution, that builds further trust between Abacus and the PE firm. That scenario makes it much more likely that the PE firm will view us as a valued partner rather than a commodity and that the relationship will lead to repeat business.

We're in very interesting times. Purchase multiples remain high, and at the same time, there are red flags in the economy with rising rates, slowing housing sales, tariffs and a business cycle that is long in the tooth.

Lenders that are less familiar with financing sponsor-backed, asset-light companies can struggle with add-ons, which can materially impact a PE group's return more than the cost of capital.

What are the key concerns in add-ons, from your perspective and involvement as a lender, for the US LMM?

For a LMM company embarking on an add-on strategy to enhance enterprise value, we've seen integration as the biggest risk. A badly executed add-on can destroy value and use up a lot of time and resources from all stakeholders, and we've seen this first-hand.

Another major concern is to make sure the sponsor is not overestimating pro forma synergies. Also to make sure they are assessing "fit" accurately and not underestimating the "cultural issues" as you're bringing together two separate companies.

Due diligence is often abbreviated as compared to what is done for a platform, so knowing what to look for is critical to avoiding mistakes.

Please feel free to elaborate on any of the topics discussed or address those not yet brought up.

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The big question is how will the PE firms navigate these waters. And as a lender, for every new deal we will have to think realistically about a cycle, a low-growth environment and the potential impact of these to our portfolio. That said, Abacus has a seasoned team, has weathered cycles before, and been there to support our PE customers and their portfolio companies through tough times. The benefits of experience are particularly pronounced in more challenging times.

About Tim Clifford and Sean McKeever

Tim founded Abacus Finance in 2011. As the firm's President & CEO and member of its Investment Committee, Tim brings more than 30 years of experience in lower middle market (LMM) lending. Previously, Tim founded and served as Executive Vice President and Head of Amalgamated Capital, a LMM leveraged-lending business for Amalgamated Bank. Prior to AmalCap, he was a Managing Director and Principal for Churchill Financial, and Head of its Boston office. Before that, Tim founded the leveraged-lending practice of Comerica Bank's Technology & Life Sciences division, and was a founding member of the acquisition finance group of FleetBoston Securities.

Sean is a founding member of Abacus Finance, with more than 15 years of experience in leveraged finance. As Managing Director & COO, Sean is a member of the Investment Committee and responsible for the firm's underwriting and portfolio management activities. Previously, he was a founding member of Amalgamated Capital, where he led the underwriting of senior-debt financing. Prior to AmalCap, Sean was a Vice President at Churchill Financial, and was a founding member of the Leveraged Finance Group at Comerica Bank. Sean began his career as an Analyst / Trader in the secondary securitized and unsecuritized mortgage debt market.

We know (and you know) you've got 10 things on your plate at all times, every day. Wouldn't it be incredible to collaborate with a lending partner who is the antidote to unnecessary complexity and uncertainty?

At Abacus Finance, we're a direct lender focused exclusively on providing cash flow-based, classic senior debt for companies with $3-15 million in EBITDA. And we've structured our culture and business around one objective: to make our client's life easier.

It's that simple.

That's how we've put over $2 billion in commitments to work for our lower mid-market private equity clients.

Give us a call at (212) 850-4620, and let's talk about making your next deal – a lot easier.

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