# Q2 Deal-making: Sponsors seek to close deals early as competition remains intense

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- Total deal value grew 24 percent in Q2
- Less cyclical businesses are more favorable
- Lenders, GPs push back on heavily adjusted earnings

Dean Mihas, managing director at GTCR. Photo courtesy of the firm.

Large private equity firms got more aggressive as deal activity heated up in the second quarter.

Some firms are going the extra mile to win deals, whether it's by getting in front of the buyer early, preempting a bidding process or by offering full-equity bids to demonstrate commitment, bankers and GPs told *Buyouts*.

So even though fewer deals were done in Q2 than the previous quarter, the overall value of deals jumped by more than 20 percent, according to *Buyouts* research.

"I am impressed by how active and aggressive larger-cap sponsors are in covering us and those businesses," said **Aaron Sack**, head of **Morgan Stanley Capital Partners** in New York. "Sponsors have been really proactive in getting in-person meetings with us as the owners."

Acting early and fast is increasingly important. One of every five processes is cut short because a buyer made a strong bid before a company entered a competitive process, said **Dean Mihas**, managing director at **GTCR** of Chicago.

But even the fastest and most dedicated PE bidders still need to find ways to differentiate themselves.

**David Brackett**, CEO of **Antares Capital** in New York, said sponsors need to be as creative as possible in auctions, including showing willingness to reach the transaction with a 100 percent-equity bid.

Finding a unique angle that makes a bidder stand out also helps to win a deal, said **Jeff Greenip**, global head of financial sponsors at **Jefferies**, a New York-based investment bank.

"You certainly need to have a thesis that differentiates you from other PE firms," Greenip said. "Maybe it's M&A, a European or Asian strategy or a more bullish view on a sector. [Also], we're seeing some sponsors leverage their existing portfolio companies to create potential revenue synergies."

*Aaron Sack, head of Morgan Stanley Capital Partners. Photo courtesy of the firm.*

**Deal volume drops**

Deal volume declined slightly in the second quarter, while deal value increased, as GPs sought ways to navigate high prices, including by chasing add-ons to platform investments. The second quarter saw 432 sponsor-backed deals overall, a 40 percent decrease from the first quarter and a 26 percent decreased compared to Q2 2018, according to *Buyouts*' research.

While volume was down, the overall value of deals increased by 24 percent from Q1 to Q2. On the year-over-year basis, the total value of deals decreased 14 percent.

Technology, industrials and consumer products and services were the top three industries by deal count, according to **Thomson Reuters**.

Some of the largest deals included **Hellman & Friedman**'s take-private of **Ultimate Software** for $11.2 billion, **Carlyle Group**'s buyout of **Arris International** for $7.4 billion, and **KKR**'s acquisition of **Magneti Marelli** for $7.1 billion.

Outside of large-scale buyouts, many GPs are navigating the high price environment by bulking up existing platforms. For example, Morgan Stanley focuses on add-on acquisitions early after acquiring a platform, Sack said.

“The middle market is expensive right now,” Sack said. “You have to justify to yourself — to your LPs and to your management teams — that you actually have a plan in place to drive underlying portfolio-company value.”

Antares, which focuses on the middle market, saw a surge in its pipeline of deal activity in April and May. The firm also had a pickup in add-ons: year-to-date, May closed deal count is up 36 percent over the same period last year, according to Brackett.

Aside from add-on activity, the firm screened just short of 90 new platforms in April while its monthly average was closer to 55.

*David Brackett, CEO of Antares Capital. Photo courtesy of the firm.*

With seven deals closed, Jefferies was the third most active M&A adviser in Q2, following **Goldman Sachs** and **Morgan Stanley**, respectively, Thomson Reuters reported.

“We had a very good quarter,” said **Robert Fullerton**, global head of leveraged finance at Jefferies. “We did a ton of add-ons, a ton of refinancing, a ton of dividend recaps.”

From an exit perspective, some private equity firms are selling minority stakes in certain portfolio companies to generate liquidity while retaining an interest in investments they are not ready to fully exit.

Rich valuations have made timing for deals of this structure especially attractive, said GTCR’s Mihas.

“Investors who are early in their investment cycle or who like their investment a lot now still want to sell down some equity,” Mihas said. “It’s a function of both wanting to take advantage of this really robust market but participating in the growth going forward as well.”

**Less cyclical in favor**

A decade-plus into the economic recovery, the hottest assets on the market today are those considered recession-resistant, buyout pros said.

Even firms that don’t expect a recession to creep up in the next few years still do more diligence on how a new asset would perform during a potential slowdown, said **Chris Busby**, partner at **Great Hill Partners**, a growth equity investor based in Boston.

“Firms are really trying to better analyze the durability of a company’s business model during a recession… We are having very vigorous discussions of what can happen to companies during the down cycle,” Busby said.

In April, Great Hill invested in **Examity**, which provides e-proctoring services primarily to the higher education market.

“There is a recognition that education it is not tied to the [economic] cycle,” Busby said. “In fact, it can be more counter-cyclical because during a recession more people go back to school.”

With deal-makers shying away from cyclical businesses, “We are seeing a widening in multiples for higher quality, less cyclical businesses versus cyclicals, especially given where we are in the economic cycle,” said Jefferies’ Greenip.

**Push back on add-backs**

Lenders are slightly more conservative now, in large part because the markets went through a meaningful correction in December, Antares CEO Brackett said.

They also have had to adjust to new dynamics around auction processes. With buyers beginning to push back on earnings with too many adjustments, lenders are doing the same when it comes to financing.

The market is becoming a little more liquid but lenders are becoming more skeptical of add backs as they are not seeing those add backs come through, said Antares’ Brackett.

Deal-makers over the past 12 months have raised concerns about the quality of earnings they are seeing. They’ve seen adjustments ranging from earnings add-backs for annual hurricanes to add-backs for M&A expenses, they told *Buyouts*.

“Frankly, lenders are increasingly skeptical about borrowers achieving those add-backs… In prior times we were more accepting, but now we are pushing back,” Brackett said.

It’s not just lenders that are more skeptical about add-backs and revenue adjustments.

“Buyers are willing to pay high multiples for good businesses, but they are not willing anymore to pay high multiples for good businesses on really flimsy earnings, earnings that have too many adjustments or [earnings] that have too much add-back activity,” said Morgan Stanley’s Sack. “People are starting to say ‘no more on fake, low-quality Ebitda.’”