GUEST ARTICLE

In Search Of The Proprietary Transaction

By Kevin Kester, Siguler Guff & Co.

Those of us who spend our time evaluating private equity managers are quite skeptical every time we hear that this or that deal was sourced directly or proprietarily. Are sellers really dumb enough to only solicit one bid for their business? Are we to believe that successful business owners only price shop their suppliers and not prospective buyers of their business?

Of course not, unless the business is broken, and even bankrupt companies are auctioned. In the real world (a.k.a. when firms are not marketing their next fund) there are degrees of competitiveness and efficiency, and what value-oriented investors look for are situations where imperfect information, uneven levels of sophistication and less competition—as measured by the number of informed bidders vying for a business or asset—can be exploited to produce a competitive advantage.

If we agree that the proprietary deal is elusive if not non-existent, then how can we best position ourselves to capture relative value and earn higher rates of return? The simple answer is deal flow. The higher the quality and quantity of deal flow that an investor is able to process and evaluate, the greater the chances they will find the most attractive companies at the most attractive prices, assuming they have investment acumen. Obviously, easier said than done, given the vast disparity in performance among the thousands of private equity managers and funds now comprising the market. We know that most private equity managers spend the vast majority of their time, effort and resources in search of deal flow and that for different segments of the market—small, middle and large—this quest takes on different forms.

Large or mega-funds today are focusing a great deal of attention on screening listed companies for attractive take – private opportunities—but let's not forget that every competitor and investment bank is doing the same thing. Middle market firms, who are often derided for being stuck in the…well, you guessed it…middle, focus their efforts on seeking investment angles into competitively auctioned deals, because it is important to have an "inside edge" when you pay full price for a deal that was shown to 50 private equity firms and five strategic buyers.

Kevin Kester

Small funds focused on small—sub-$10 million to $15 million of EBITDA—deals also experience competition, but their quest is bolstered by market magnitude. There are 275,000 private companies in the United States with revenue between $5 million and $100 million, making up 93 percent of all companies with greater than $5 million of revenue, according to the Small Business Administration. These companies combine to employ close to 30 million people and produce approximately $4.5 trillion of annual revenue. The sheer volume of deal flow in this end of the market is evidenced by the nearly 2,900 disclosed (estimated above 8,000 when undisclosed deals are included) U.S. M&A transactions involving small companies (enterprise value of less than $100 million) that occurred in 2006, according to Thomson Financial and Robert W. Baird & Co. In other words, last year there were 32x the number of sub-$100 million transactions as there were billion-dollar-plus deals.

The data on small business is compelling. It is well documented that American small business, as defined by the Small Business Administration, comprises slightly over 50 percent of private sector employment and GDP and about 75 percent of net new job growth. In fact, during the last U.S. recession, small business actually created net new jobs and is credited, along with the Federal Reserve's loose money policy, with helping to soften the downturn. However, from an investor's perspective, one of the interesting attributes of the small business economy that leads to excessive salivation—not to mention salvation—is the aging of America. Last year, the first members of the baby-boom generation started turning 60 years old (an American turns 60 years old every 11 seconds), and this 77 million strong age cohort of people born from 1946 to 1964 happens to include large numbers of small business owners.

According to Small Business Administration data, over 28 percent of small businesses are owned by 50 to 60-year-olds and over 60 percent are owned by individuals 45 years old and over. Importantly, 40 percent of all small business owners are 55 and over and only 10 percent are under 35 and, even more importantly from the standpoint of the private equity investor, 75 percent of all business owners plan to sell their companies sometime between their 55th and 69th birthday. Similarly, pundits suggest that one out of every two privately-held businesses will go up for sale over the next 10 to 15 years. Suffice it to say that the pig is moving through the python and that more than $10 trillion of enterprise value could change hands over the next 10 to 15 years in the United States. Of course, micro-factors such as the state of the leveraged finance market, private equity fund raising market, and tax policy will have short-term impacts on the amount of M&A activity. But this will be modest and overpowered by the inevitable tidal wave of small and lower-middle market deal flow coming ashore.

The deal statistics certainly suggest that the small and lower-middle market has the prerequisite deal flow necessary to create the potential for less competitive, if not proprietary, opportunities. Furthermore, the demographic data paint a picture that illustrates a surge of supply in the coming years; however, the best way to gauge competitiveness for deals is, of course, entry valuations. In theory, a dollar of cash flow, all

GUEST ARTICLE

things being equal, should have the same value to investors. Obviously, in practice investors apply different discount rates to the cash flows generated by different operating assets based on perceived risks to the cash flow.

All cash flows are not created equal and smaller companies are usually given higher discount rates because their cash flows may be considered less predictable or less stable—essentially riskier. In general, this makes sense and is illustrated by the median purchase price multiples for different sized businesses. In 2006, companies of less than $100 million in enterprise value sold for a median purchase price multiple of 8.4x EBITDA, compared to 9.7x EBITDA for companies with enterprise values from $100 million to $499 million, and 12.0x EBITDA for enterprise values of $500 million to $1 billion, according to Thomson Financial and Robert W. Baird & Co. So, the inevitable question is whether or not you want to pay nearly 43 percent more for a dollar of cash flow generated by a $750 million company versus a $50 million company?

Obviously the devil is in the details with respect to the perceived risk of any company's cash flows, as investors consider characteristics such as barriers to entry, product or customer concentration, cyclicality, and other qualities to assess volatility. The enormous size of the small company marketplace suggests that investors should have a greater chance of finding the smaller businesses that are, in reality, less risky. Smaller businesses are often considered more nimble and better able to adjust to changing market conditions. They generally have higher growth rates or potential as they can position their products or services into more attractive niche sectors of the economy and they sometimes exhibit oligopolistic and even monopolistic behavior while flying under the radar screens of regulators. The important point here is that size is not necessarily correlated to risk, but it does appear to be highly correlated to price (valuation).

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A quick look at the public markets provides additional fodder for this discussion. Through the first quarter of 2007, the Russell 1000 Index (Russell's proxy for U.S. large cap stocks) had a P/E ratio of 16.6x, while Russell's small cap stock index, the Russell 2000, had a P/E ratio of 20.5x. The delta suggests that, in aggregate, small cap stocks are about 23.5 percent more expensive than large cap stocks; however, Russell also notes that its small cap index has approximately a 14.8 percent long-term growth forecast versus about 11.8 percent for their large cap counterpart, which helps explain the relative valuations. Paradoxically, this appears to be the opposite of what we see in the private markets, where smaller companies, with presumably higher growth rates, cost less. So how then do we reconcile the intellectual conflict that small public companies are generally more expensive than large ones, while the reverse appears true in the private markets? Like most price debates in life, chalk this one up to supply and demand. Lacking the transparency and price discovery afforded the public market, the private market magnifies the inefficiencies and supply-demand imbalances that exist in the small and lower-middle market, creating compelling opportunities for investors that can tap into the huge reservoir of potential deal flow.

Now, I am as quick as the next person to reference Benjamin Disraeli's remark made famous by Mark Twain that "There are three kinds of lies: lies, damned lies and statistics." And I certainly have thrown a bunch of statistics at you thus far, so please resist the temptation to call me a purveyor of statistics or lies for that matter. In return, I will purvey no more data, but instead summarize and exit gracefully.

If the simple answer to capturing relative value and higher rates of return is deal flow, then the small and lower-middle market win—hands down. With a massive supply of companies and an apparent lack of interest by institutional investors, this end of the market has the supply-demand characteristics that create opportunities for less competition and better value. Institutional investors have difficulty investing in smaller funds that target this end of the market as they cannot justify the resources relative to the opportunity to deploy significant capital. These constraints, along with the added effort of evaluating and conducting due diligence on small managers and their companies, generally limit excessive demand, even when most investors acknowledge the merits of the investment thesis.

Additionally, mainstream business media's disregard for small business (how many knew that President Bush proclaimed April 22-28 as National Small Business Week?) only serves to further curtail attention from the institutional investment community. As long as these attractive investment characteristics exist—and there is no indication that the structural inefficiencies and significant supply-demand favorability of the small market is changing in any way other than more positively—investors will continue to find great deal flow and great value. So, the next time you are listening to a private equity manager tell you that this or that deal is proprietary, before you start into your best Animal House impression of coughing B.S. under your breath, you may want to ask if it was a small deal. ❖

Kevin Kester is a managing director at Siguler Guff. As a member of its investment staff, he oversees the firm's work on its Small Buyout Opportunities Fund, where he has responsibility for fund manager screening and selection, terms and conditions negotiations, and performance monitoring.