Deal Outlook: Facing Fierce Competition for Deals, PE Firms Work to Adapt

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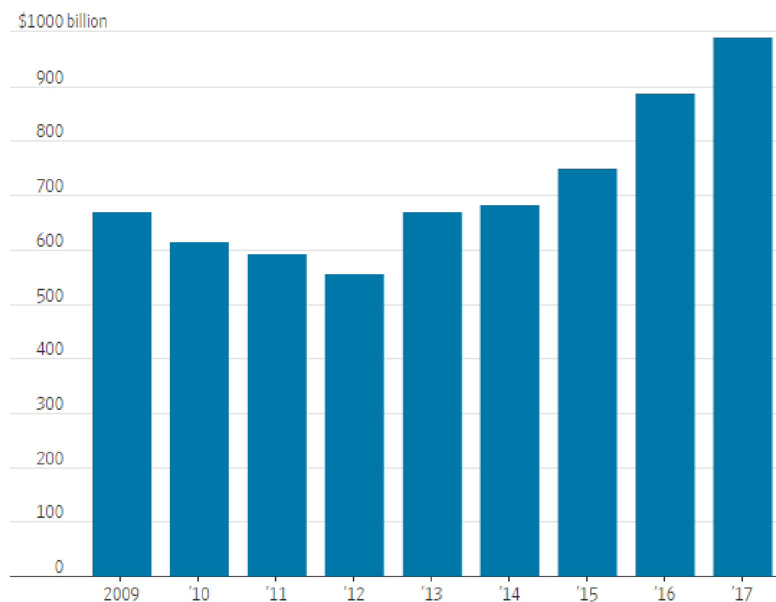
The private-equity industry anticipates the robust pipeline of deal activity seen in 2017 will continue into 2018, although many investors are becoming more frustrated, believing that fierce competition for deals and high valuations will only intensify further.

As buyout firms look to stand out from their competitors in order to land deals, they are feeling pressure to be more innovative in the investment opportunities they pursue.

"[The] corporate M&A cycle is really heating up, and I think that will continue to 2018. There's more optimism about [the] economy," said Joseph Baratta, global head of private equity at Blackstone Group.

Private equity sealed 514 transactions with a total deal value of $232.36 billion in the U.S. as of Dec. 8, 2017, according to research firm PitchBook Data Inc. Private-equity investors backed 660 transactions worth $236.22 billion over the corresponding period in 2016.



The low cost of capital and rising competition among strategic and financial acquirers continue to drive up valuations, creating pricing pressure for private-equity firms across all sectors. The universe of potential acquirers also is broadening, driven in part by the entrance of sovereign-wealth funds and family offices. To survive against such forces, private-equity investors increasingly feel the need to become more selective and resourceful in the ways they buy and manage the companies they acquire or risk their return threshold altogether.

“You have to roll up your sleeves and be even more creative in getting the returns that the LPs want, given the entrance price point,” said Bill Sanders, global head of the financial sponsors group at Morgan Stanley. “If you’re a buyer, the only difficulty is finding the angle on each asset to actually grow it and get the return that you need.”

The deal market has held up at impressive levels, fueled largely by strategic and financial buyers who are eagerly turning to acquisitions for growth.

“Corporate CEOs seem to be more willing to take risks on large scale M&A transactions. Usually when that happens, that’s a good thing for private equity because there are noncore asset divestitures that happen after big corporate mergers and acquisitions,” said Mr. Baratta of Blackstone.

Pricing Keeps Investors on Their Toes

Despite the fact that much of the private-equity industry remains optimistic that 2018 will prove to be another fruitful year for deals, many are looking at the merger and acquisition landscape with caution.

“Earnings continue to be strong, so asset prices are very high and they’re at multiyear highs in terms of multiples,” said Stephen Wise, a managing director at Carlyle Group and head of the global health-care team at the firm. “It’s a very difficult environment to invest in.”

In addition to competition, the enormous availability of debt is helping to push up valuations.

“You have this proliferation of nonbank lenders that continue to drive leverage ability to all-time highs,” said Rich Lawson, chief executive officer and a managing partner at midmarket-focused HGGC.

Deals that traded for about 10 to 11 times earnings before interest, taxes, depreciation and amortization in the early part of 2010s are now trading for 16 to 17 times pro forma Ebitda, Mr. Lawson said.

Against the backdrop of such valuations and a continuing healthy buyer appetite, private-equity backers have busily tested potential exits for their portfolio companies, sometimes with false hope.

“As long as this remains a sellers’ market, we’ll see shorter PE hold times,” said Jeff Greenberg, chairman and chief executive of Aquiline Capital Partners. “The high price expectations on the part of sellers have led to some broken processes.”

For many, such uncertainty is turning into a sense of unease about competing effectively in sale processes and achieving the necessary growth in companies thereafter.

“Many of the firms are frustrated at the pricing that’s out there, which of course makes it harder for them to generate the returns,” said Christopher McMahon, head of global mergers and acquisitions at investment bank Robert W. Baird & Co.

"Private-equity investors feel that they're having to pay multiples that they prefer not to pay, and as a result, it puts much more pressure, and their margin for error is much thinner," Mr. McMahon added.

As the price of entry gets more expensive, the bar continues to get higher for private equity when choosing what assets to pursue and how aggressively to chase them. Certainly, the overheated pricing atmosphere is propelling firms to think critically about their investment theses. Private equity is also embracing a more flexible approach toward deal sizes and structures.

"When we dip down into doing smaller deals, it's a way for us to get a lot more growth, given the high valuation environment," said Mr. Wise of Carlyle. "We do find those opportunities [usually in] founder- and entrepreneur-driven businesses, and [we] get creative in how we structure those deals."

The high-end of the buyout market, which typically includes transactions requiring north of $500 million in equity, can be less competitive, he added.

The middle market is expected to remain particularly active for deal making as corporations and investors alike look for fragmented sectors with a strong trajectory for expansion.

"During a contraction in the market, there's a lot more competition in the middle market," said Lee LeBrun, who is head of M&A North America at investment bank Rothschild & Co.

KKR, for instance, made a December 2017 foray into the midmarket industrial sector by purchasing Hyperion from Sandvik AB for 4 billion Swedish kronor ($470.8 million).

Take-Privates Back in Fashion

As valuations in the private market overheat, private-equity firms will continue turning to the public markets, acquiring undermanaged and underappreciated companies of all sizes.

With private-market and public-market valuations continuing to narrow, investors are tapping into the promise of publicly traded companies and their growth trajectory. The year 2017 provided plenty of evidence for this shift: Sycamore Partnerstook Staples Inc. private for about $6.9 billion, while a consortium of investors including Energy Capital Partners, Access Industries Inc. and the Canada Pension Plan Investment Board said it would acquire publicly-traded electricity generator Calpine Corp. for $5.6 billion.

"Public to privates are back in vogue," said Mr. Sanders of Morgan Stanley.

Carve-out transactions are likely to remain active in 2018, continuing a trend on display in 2017. Among the largest private-equity deals of 2017 were Blackstone's acquisition of benefits outsourcing companyAon Hewitt LLC for up to $4.8 billion from Aon PLC and Bain Capital's $3.2 billion purchase of hygiene and cleaning services provider Diversey Inc. from Sealed Air Corp.

Blockbuster tie-ups—coupled with the predominance of activist investors—will pave the road for more divestitures and spinoffs in 2018.

Still, sponsor-to-sponsor transactions have dominated the deal market for private-equity firms since the financial crisis and they will likely get more pronounced.

“Board rooms are much more optimistic about deal activity and [the] performance of their businesses and investing in their businesses today,” said Brian Bernasek, managing director and head of the global industrial and transportation team at Carlyle.

Still, investors are eyeing a mixed bag of factors that could affect M&A in 2018. Geopolitical risks—particularly those involving North Korea and Russia—could impact acquirer appetite, as could tax reform, which could complicate the use of interest deductibility by affecting the amount of debt firms can put on companies.

“For us, we’re looking at things pretty defensively. We’re assuming a correction and a downturn in the economy. We do see things slowing down,” said Jim Zenni, president and CEO of Z Capital Partners, while acknowledging that he doesn’t expect to see major changes to take place as long as interest rates stay low and liquidity remains high.

The big question of a potential market correction continues to loom over firms navigating through what has been a frothy market for an extended time period. The M&A atmosphere is undoubtedly getting more difficult, but private-equity investors will remain a significant force in driving deal activity.

“If there’s a valuation reset of the public equity market, it’s going to have an impact. If there’s a dramatic spike in the cost of capital on the debt side, that’s going to have an impact,” said Mr. McMahon of Robert W. Baird. “But absent those activities, it’s hard to see private equity dramatically slow down.”