With 2016 in the rear view mirror, dealmakers are now focused on 2017. At the end of 2016, Mergers & Acquisitions hosted a roundtable to explore what dealmakers can expect in 2017. RSM US LLP sponsored the event. The wide ranging conversation covered how the private equity market is changing, how the credit markets are impacting M&A activity, where deal flow is coming from, how private equity firms and strategic buyers are winning deals and what challenges dealmakers face as they transact in 2017. What follows is an excerpted version of the conversation.

Danielle Fugazy (moderator): How would you characterize market conditions today?

Michael Fanelli (RSM): We’re at a time where middle-market deal volume is actually down 15 percent to 20 percent in terms of closed deals. However, there are a lot of interesting dynamics in the marketplace. The lending market is pretty good and dry powder is actually at the highest it’s ever been, but there seems to be a supply-and-demand issue. There aren’t as many good-quality companies for private equity firms to acquire these days. As a result, you’re seeing a very competitive landscape out there—investment bankers are holding very competitive processes.

Brad Vaiana (Winston & Strawn): The companies that have been taken through one turn of private equity ownership are now looking to trade either to a secondary or a strategic. Those companies have always, and continue to be, really hot assets. They’re trading at very high multiples and they are easily financeable businesses.

Mike Hogan (Harris Williams & Co.): We are in an environment where the level of private equity dry powder is incredibly high and private equity firms continue to raise significant amounts of new capital. There’s a lot of pressure to deploy that capital. Large corporations have generally healthy balance sheets and are using M&A to supplement organic growth, which is helping drive increased strategic activity. This combination creates a large demand for high quality assets, making it a great time for sellers to come to market.

Mark Poff (Swander Pace Capital): Through the lens of consumer products, because that’s where we invest, it’s definitely a competitive market. In consumer, in addition to the dry powder that you have with private equity buyers, you have strategic buyers that have a lot of interest in acquiring assets; they are diving down and looking at smaller and smaller companies and it adds pressure on a competitive process.

Scott Spielvogel (One Rock Capital Partners): Our strategy is more special situations, corporate carves-outs, and the like. The strategies typically don’t like the uglier, hairier, messier situations, and that’s what we focus on today. I agree that it’s a tough environment for nice, clean businesses. And we’ve definitely had to pick our spots because there are some buyers out there that are willing to overlook some of the complexities and justify their involvement in a business because there is pressure to put capital to work in this environment.

Fugazy: Do you anticipate the market to remain competitive through out 2017?

Spielvogel: It’s hard to say. What we’ve found over
the years is that we are not good prognosticators of what happens from a GDP perspective, so we don’t try to play the market. Interest rates have started to creep up and that may have an effect. The election certainly created a scenario where there could be some tax breaks, there could be some repatriation of capital back to the U.S. for reinvestment in the North American market, which could be positive, but that’s highly dependent on whether the new President can work with Congress to get that achieved. It’s hard to say what sort of unintended consequences that will have on the M&A market. I think we just have to be ready to react.

Fugazy: How are firms accelerating growth at the portfolio level? Are private equity firms doing anything different today?

Poff: I would say that it’s incumbent on the private equity owner to help drive growth and drive the business forward. It’s really about the actions that you can take to build a portfolio company. That can be everything from focusing on new markets to extending channels. This greater emphasis on value creation is not new. A lot of what we see on the consumer side will be a business that is very good in one particular channel, but there are owners who aren’t in a position to expand the business into another channel for various reasons. In those situations a private equity firm can bring in the resources, best practices, and experience from other categories to help move businesses into other channels and create growth.

Vaiana: When I first started working with private equity funds in the late 1990s, it was really unusual to see a private equity fund that had a dedicated business development person as part of their team. Even as you got into the 2000s, it was still a bit unusual to see that. But over the last five years, I’ve seen a trend in the middle market where people are dedicating internal resources and hiring a dedicated business development person whose role is to go out and find not just new platform investments, but also add-ons for portfolio companies as well. This speaks to private equity shops that are recognizing that they need to continue to build infrastructure internally to create opportunities. That trend will continue.

Fanelli: The reality is we’re in a relatively slow-growth environment, and people are buying growth. Add-on acquisitions were 60 percent to 65 percent of total closed deal volume at the end of 2016. There’s a big push toward buying businesses in fragmented industries and having a roll-up strategy. In a lot of the instances, it’s working because it also typically helps lower the average multiple paid for the total investment. That is a recent trend I expect to continue into 2017.

Fugazy: We’ve been in a strong M&A environment for quite some time now. People are thinking about a potential downturn. How are the dealmakers thinking about the cycles today?

Poff: You could have made an argument that we were at the top of the cycle two years ago. It kind of had that end-of-the-cycle feel, but in the lower and middle market—and particularly in consumer—we don’t spend a lot of time thinking about where we are in the cycle because with that thinking, you would have said two years ago, ‘Well, maybe I should hold off on deploying capital, because I think we’re at the top of the cycle,’ and the market hasn’t really changed in the last two years.

For us, it’s about finding good assets that you can do something good with in any market and bring value to the table. If we do those things there will be a strategic buyer for our company at the end of the day. Business owners in this market sell more based on the evolution of that business, or the age of the entrepreneur, or the evolution within the family. Those factors are cycle-independent. You could drive yourself nuts thinking about where the cycle’s going to be. If you’re a private equity firm where you need to put money to work to generate good returns for investors, it’s about waking up every day and focusing on investing.

Spielvogel: As someone who focuses mostly on
industrial manufacturing and industrial services businesses, the expectation on us from our investors is to keep deploying capital. You can’t sit out the macro environment, expecting that a downturn is coming. You just have to price it into the deal and structure it to be able to withstand the twists and turns that the business may take in a downturn. Price becomes that much more important when you are looking in a choppier environment or expect a choppier environment on the horizon. You just have to be prepared for it.

**Vaiana:** Cycles affect every investor and every fund differently. There could be a cycle that absolutely knocks out retail or consumer, but doesn’t have the same level of impact on healthcare or industrial. The funds that have been successful in the past are not trying to game the cycle. They partner with good financing partners that they trust and they work through the cycles. Good partners won’t ever make a deal cycle-proof, but they could make it a little cycle-resistant.

**Poff:** And even within a sector like consumer products, there are sectors within that sector that are completely cycle-independent. When you think about pet products, for example, they’re completely cycle-independent. Consumers are going to continue to buy pet food regardless of if GDP goes up or down.

**Fanelli:** For this cycle and whenever it’s transitioning, there doesn’t seem to be anything systemic that would make it negative in the near-term. We talk a lot with our chief economist at RSM, Joe Brusuelas, and right now everything is okay, but it’s slow growth. Wages have been okay, new jobs have been okay, and housing has been okay. So all the different things behind the scenes from an economic standpoint seem to be okay. There doesn’t seem to be anything systemic behind the scenes that would put us into a very near-term downturn.

Actually, if President Donald Trump and the Republican Congress are able to actually put in some new investment friendly policies it actually may benefit the middle-market economy. However, the long-term is kind of up in the air. Who knows at this point, because we don’t know how some of these things are going to turn out. But I think 2017 is going to continue to be a good year for sellers because there’s really no systemic reason why lending would be tougher or why multiples would go down.

**Fugazy: What are some differences we may see in 2017?**

**Vaiana:** The club deal, which was all the rage five, six, seven years ago, has been replaced by the co-invest deal. The bigger funds have moved away from clubbing and instead rely on co-investments to acquire larger targets. That should continue.

**Fanelli:** We are seeing larger private equity firms coming down market for deal flow because there aren’t as many big deals. Similarly, we’ve seen a lot of the middle-market funds going down to the lower middle-market to find deal flow, and maybe it’s not for platforms, but for add-on acquisitions.

**Spielvogel:** Now you see the Carlyles of the world and even mid-market firms like AEA raising separate funds that have a strategy focused on smaller deals. I suspect this trend will remain because the larger players are looking to grow their assets under management and it certainly makes sense for them to try to compete in all parts of the market.

**Vaiana:** That permutation of creating a sub-fund with a strategy that’s designed to invest in that lower middle-market asset class, or the middle market, is the only solution long-term. On a one-off basis you might see one of the mega-funds come down into the middle market for a specific reason, but in general the math doesn’t work. The answer is creating a new dedicated sub-strategy, which firms are starting to do.

**Poff:** There is an important point here though: what do you do with the business afterwards? In middle-market businesses, it’s not just the investment, it’s what
Hogan: If you start looking at deals that are $500 million to maybe $1.5 billion, we’ve seen a big migration down from the mega-funds — groups like KKR, Apollo, or Bain Capital that five to 10 years ago would be looking at just larger deals are coming down market and actively participating in deals that are $50 million to $75 million of EBITDA where there’s a buy-and-build opportunity. We expect to continue to see them pursue those kinds of deals with the ability to find a great platform where they can do a lot of smaller add-on acquisitions that are six to eight times EBITDA. Even if they’re paying 10 to 12 times for the base platform, that’s attractive math for them.

Fugazy: We are constantly hearing about sector-focused funds today. I assume that will continue in 2017. But can firms find enough quality deal flow if they become so niche?

Spielvogel: This is commentary on people looking for returns out there. If you look across the landscape—at the moment there just aren’t a lot of places for institutions to achieve their investment return objectives other than in private equity. Private equity firms are trying to come up with new products to put that capital to work for their LPs who are asking them to please take more capital and generate strong returns.

Fanelli: In general, we are seeing more specialization, and therefore, many of our clients are asking us to be more specialized. The market is becoming such that if you don’t know that industry, subsector, all the players in that subsector and all the deals in that subsector, you’re not going to win that deal, and we’re not going to be the service provider on that project if we don’t have that knowledge.

Hogan: Being sector focused for funds may be less of a function of structurally how the fund is formed, i.e., it’s a consumer fund like Swander Pace, but rather how the investment thesis is sold to investors: “There are three silos that we do, and these are the things that we do well. This is where we’re going to focus given our strong track record investing in those sectors.’ Given the market is more competitive, there is a need for sponsors to have a deep understanding of sector dynamics and key players as well as relationships with industry executives well in advance of finding out about an opportunity in order to put themselves in best position to prevail in a competitive process.

Danielle Fugazy: Does sector specificity influence you during a process when you’re looking for buyers?

Hogan: It influences how we think about relative risk of a buyer as they move through a process and at what point do we feel like they have a well-developed enough view of specific industry and business dynamics, as opposed to somebody coming in and just being smart and trying to get up to speed on all of that. Today, more than ever, it’s critical as we think about who our clients ought to spend time with in the context of a process.

Vaiana: It’s a game-changer. In a highly competitive process, it adds certainty of close and it adds to the potential future value of that rollover investment. Unless you’re prepared to go way up in value, which people don’t like to do, if you’re trying to create a differentiating factor for yourself in a competitive marketplace, knowing the industry without having to resort to consultants and consulting reports totally separates yourself from the rest of the herd.

Fugazy: In addition to becoming more sector focused, are there any other practices that you’re seeing dealmakers do today that are giving them a leg up on the competition?

Fanelli: On the buy side, we are getting phone calls...
earlier than ever. We’re getting phone calls, not when they have a letter of intent signed, but now buyers are calling and saying, ‘We are in a process where we’re hoping to get a letter of intent signed in the next two weeks. Can you help start looking at this with me?’ And whether that turns into actual detailed work or not, TBD, but we’re seeing more and more pre-LOI work.

There are even certain instances where the banks are saying, ‘You have 30 days. We want all of the potential buyers to do as much work as they think they need to do, and one of you will get one week of exclusivity after that.’ There was an instance recently where we went in, and our private equity firm client said, ‘We want this asset. We think we can differentiate ourselves. We want to turn on financial, tax, IT, legal due diligence work streams.’ They spent money doing that. And ultimately they found things about the company that changed the valuation. And so now they had to go to the investment banker and say, ‘We’ve spent X amount of money doing work because we are really interested in this asset. However, we found A, B, and C.’ And they also had to convince the banker that the other three firms, if they haven’t brought it up, they’re going to, and they’re going to ask for the same thing. The good news is they were able to move forward, but it’s tricky.

**Fugazy: You could potentially be penalized for doing the work?**

**Fanelli:** It’s a risk, but you want to go in to a deal knowing what to expect.

**Hogan:** In the context of a process, that’s why you want to have multiple parties working. It is also why it puts the onus on the seller to really anticipate all of those issues upfront and spend an enormous amount of time thinking through not just the basic positioning and how people are going to look at it, but also what are the things that buyers are going to find when they get in and dig three layers deep. Sellers have to be ready to proactively address those issues and think through how that impacts process. It definitely requires a much different level of preparation than historically.

I’d say there’s also a flip side, where we see successful investors coming in, and because of their industry expertise, they’re identifying opportunities that maybe management doesn’t have in their strategic plan.

**Fanelli:** It’s a competitive environment, and the behavioral change is that you have to just act with a lot of conviction. And I think the conviction might mean spending money on advisors earlier. It might mean doing more work with consultants or lining up managers or whatever it is to be able to demonstrate credibility, conviction and knowledge in the space.

That’s where sector focus really does matter, particularly in a competitive environment like this, where it’s not just that you found a white paper and said, ‘Hey, I understand this category,’ but when you’re sitting down with an entrepreneur or a management team, you’re talking about real examples of where you helped expand a business or develop a new channel.

**Fugazy:** Do you expect the environment to remain this competitive in the first half of 2017?

**Spielvogel:** There’s no reason for me to think that 2017 is going to be any less competitive than 2016. And everyone that I’m talking to does not see anything that would be negative to middle-market M&A in 2017, so I’m looking forward to a good year.

**Vaiana:** As long as lenders are willing to lend, I think we’ll be okay in 2017. That tends to be the driver of a lot of the sponsor-backed activity that is keeping multiples high.

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*Mark Poff, Managing Director, Swander Pace Capital*
**Hogan:** Short of some sort of shock to the system on the financing side, which is hard to see now, we’re going into 2017 prepared for the market to look a lot like 2016. The underlying drivers here of growing interest from strategic buyers and abundant dry powder on the private equity side, along with the ongoing evolution of businesses that continue to grow and develop to a point where they need a sponsor, we don’t really see changing in the near term.

**Fugazy:** What challenges are thinking about going into 2017?

**Vaiana:** For me, the challenges are always the same. You need to be disciplined, you need to be patient, you need to be non-reactive to everyone else. In a competitive environment, you need to stay the course, continue to manage your portfolio the right way and be measured and smart about where you participate and when you participate.

**Poff:** The positive aspects in M&A that don’t change in 2017 from 2016 also means that the challenges that the industry faced in 2016 persist in 2017. These are the same challenges that have been here throughout the cycle—finding quality assets and dealing with competitive pricing.

**Hogan:** Because of the challenges that these guys face in putting capital to work, as a representative to sellers, one of the difficulties is buyers are less patient with processes and want to make a decision earlier. So you can have a dynamic where processes thin out more quickly if you’re not very careful about fostering the right interest. It’s not just about numbers and how many visits you have and how many buyers are in the mix, but it’s about having the right buyers in the mix and an ability to either draw some interest from strategics or financial sponsors that have enough industry expertise that they’re looking at it from a little bit of a different perspective.

**Fugazy:** Do you think private equity or strategic acquirers will be more active in 2017?

“*If you look across the landscape—at the moment there just aren’t a lot of places for institutions to achieve their investment return objectives other than in private equity.*”

Scott Spielvogel, Managing Partner, One Rock Capital Partners

**Fanelli:** In certain instances it can be tough for the private equity firms from just a pure valuation perspective. It depends on the growth prospects of the larger corporations in 2017. And if $2 trillion of cash from overseas comes back to the U.S., the question becomes do these companies end up putting that money to work in M&A versus research and development and infrastructure?

**Vaiana:** If Donald Trump has his way, and if he’s to fulfill his campaign promises, then I would expect strategics to be incredibly active, because he’s trying to promote bringing the money back, putting the money to work, lowering taxes on companies—this should increase the amount of cash available to strategic buyers. That, coupled with the fact that the longer we get in an up cycle, the more skittish people are going to be about ultimately hitting a brick wall, and you’ll start seeing advisors counsel sellers towards exiting and getting out before it’s too late type thing.

**Hogan:** We tend to see strategics more active in the later stages of the cycle. In the early stages of the cycle, either they are so focused on what’s going on in their businesses, or they just don’t have the drive to go out and do something when they’re in a challenged market, despite the fact that that’s probably the best time to find attractive assets.

**Poff:** The fundamental reason for strategics to do acquisitions is to buy growth and innovation. As the consumer products markets continue to develop and there’s growth and innovation out there, the strategics can’t develop it themselves, and they’re going to have to buy that. That’s independent of tax policy. That fundamental trend will keep strategics active in the processes, but also, from a private equity perspective, that means strategic buyers are there, and if you can find those businesses and help them develop, grow, and add value, those strategic buyers will still be there in 2017 to 2018 and beyond.