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TOP TAKEAWAYS

SUPER CHARGING SELLERS' STRATEGIES FOR TODAY'S MARKET

Fueled by historically low interest rates, all time high levels of committed—but unallocated—capital and impending tax reform, private equity deal volume and values have reached new, record-breaking heights, and they continue to rise during what everyone predicts will be a very strong fourth quarter. Frank Steinherr, co-head of the Private Equity Practice Group at McDermott, was joined by industry leaders to make sense of this very frothy and seller-friendly deal environment. The panel included:

- Megan Preiner, Partner, Thomas H. Lee Partners
- Geoff Lieberthal, Partner, Two Sigma Impact
- Chris Harris, Managing Partner, FFL Partners

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Refining Exit Theses

A shift in the last five years has driven sellers to develop more strategic thought around the exit process. It used to be that sellers would consider selling once they reached their average hold time in a very reactive way. Now, sellers are taking a much more systematic approach and considering the exit strategy right out of the gate. This has resulted in a more strategic vision around the end goal of an investment. In the current market, deal volume is only part of the story. There are multiple avenues for liquidity and exit.

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Be Ready to Adjust

Before you sign a contract to buy a business, you want to have a point of view as to where you think that part of the industry will evolve and if the asset will be highly valued by the world five years from now. But you also need to react to reality. For instance, while COVID-19 was completely unexpected, it greatly benefited certain types of businesses and opened up new channels for others. It's important to be continually underwriting the deal and understanding what options are in front of you. This year, in particular, has made everyone rethink their portfolio and when to exit.

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Rise of Continuation Funds

This relatively recent phenomenon is a good option for assets that you have a lot of conviction about and don't feel it's the right time to exit. It can also be a tricky proposition because you are both the buyer and the seller. The key is to be painstakingly careful in the evaluation process as well as garner support from your existing limited partners (LPs). It's also important to balance the desires of all the involved stakeholders. Within the LP base, people may have different requirements, and this option can potentially provide for flexibility to allow some of the LPs to take cash off the table or roll into the new transaction with the same waterfall.

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Multiple Exit Strategies

One of the challenges as a seller is that it's an incredibly busy market. We'd love to have all of our optionality, but there is a cost to that now. When you're running a sell-side process, you have to have in mind what the hook is for buyers. Who really has a chance, and how will they engage? It's not a given. For instance, if it seems likely a strategic buyer will buy, it's very difficult right now to get financial interest. The buy side is in a state of triage right now and must narrow focus to maximize the probability of the option being successful. A buyer will be less inclined to spend time on something if the seller is pursuing multiple paths.

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Changing Buyer Behavior

Buyers have become much more discerning. There's no more time for kicking the tires; when buyers are interested, they're competing to win. People now show up before the process even starts, proactively targeting assets and getting to know the management team and the sponsor. This method means those buyers are concentrating their efforts on the three or four assets that most strongly capture their attention. Smart sellers are pressure testing their assets and doing a lot of front-end work to avoid surprises, while giving select buyers the access and information needed to move quickly.

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Successful Auction Processes

As a seller, you're now courting buyers well before you run a process rather than engaging a banker and then going out to a number of buyers. It's about controlling the narrative as a seller and doing the sell-side market work. It's become something of a standard to have a sell-side market report in order to set the stage and control what the other side will react to and push against. It can also level the playing field so no buyers have a major information advantage.

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Could This Be a New Normal?

If you look at all the factors that have contributed to this seller-friendly environment, some are temporal and some are likely to be lasting. Dry powder won't disappear overnight, and there will be a growing number of healthcare assets coming to market each year. The move of debt from bank balance sheet to non-bank lenders is a secular trend, so debt financing may remain plentiful and relatively low cost. Yet with businesses being bought so quickly, the bandwidth on the buyer side will become an issue the longer this frenzied pace continues.

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