Mass exodus
Private equity exits in 2015

Private equity’s exit market has become increasingly receptive in recent years, with sponsors selling their portfolio firms at both record volumes and values. Yet as the public markets start to wobble and the number of companies fit for exit dries up, are these levels sustainable? Toppan Vite, in partnership with Mergermarket, asked four industry-wide experts for their thoughts.

What is driving the extremely high exit volumes and values in recent times?

It has been driven by five years of cheap money, which has investors chasing growth and chasing yield anywhere they can find it. Compounding that, the debt markets for the past two years have been as robust as they’ve ever been. Certainly in the technology space there’s been a very strong macro environment driven by these factors. It has led to a strong market for sellers and a high volume of deal activity at robust valuation levels.

It’s obviously a seller’s market, as Chris says, so everybody’s trying to sell anything that isn’t nailed down. There’s a confluence of good events.

The strategic buyers are out there in great numbers. They really don’t have a lot of opportunities for organic growth, so they are looking at acquisitions. They also have a lot of cash. On top of that, the debt markets have been providing lots of cheap money.

The public markets have also been high, as you know, so for a public company buyer it’s easier to pay a little more and get something that’s still accretive. There’s a little bit of pent-up demand for sales as well – people trying to clear out the cupboard from things bought in 2007 and 2008. So you’ve got interest on the seller’s side, ability on the buyer’s side and a lot of supporting factors in the debt and equity markets. What we’re seeing is a result of all those things coming together in the last year.
As a boutique firm, while we do pay attention to the macro causes and macro events, there’s enough other things unique to our market – renewables – that we spend time thinking about.

My belief is that the sector has performed extremely well over the last number of years, including during the meltdown. When you start thinking about contracted wind projects, contracted solar projects or virtually any other long-term contracted asset, the technology works – the wind is blowing, the sun is shining. There might be short-term variables around, but over any medium term, the projects have performed versus other asset classes very well. What we’ve then seen is increased amounts of allocation across pension funds, SWF, private equity (PE) funds, the formation of a number of infrastructure funds, and a bunch of direct investments from institutional investors into the equity of long-term contracted projects. All these factors have driven high exit volumes in the sector.

In terms of values, you’d have to say two things have been driving it in the last eight or nine months. One has been low interest rates and the lack of suitable alternative investments. And secondly, one would have to look, at least in the US markets, at the yieldcos. Up until recently they’ve been performing really well, although much like many of the other equity markets, the bloom is off that rose over the last few weeks and months.

I think it’s twofold. One driver of higher multiples are public company buyers. Public companies – particularly the larger ones in the UK and the US – are under intense pressure to keep their earnings up when the stock is so high. The easiest way to do that is to grow externally, so they buy other companies or assets. Although the markets have recently cooled, the high earnings multiples of public company buyers allow them to make accretive acquisitions at high multiples.

The second driving force to me that’s pushed up exits are private equity and similar funds. Private equity funds engaged in a significant number of leveraged buyouts between 2006 and 2008 that now need to look for exits. On top of this, you’ve got a lot of PE money that’s been sitting on the sidelines during the recession that needs to be spent. There
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are literally hundreds of funds out there now both in Europe and the United States that are chasing larger mid-market deals. I frequently represent PE backed companies for sale in these markets. The interest in these companies is so strong that a PE buyer must pay a premium multiple to get them.

We’re also seeing a bit of a mid-market renaissance as Chris mentioned. The bigger deals are getting harder to do – pricing is high, competition is stiff, inventories are low. However the mid-market is robust, with more deals below $500m. There’s still big blockbuster deals out there obviously in terms of dollar value, but in terms of number of deals, we’re doing a lot more in the mid-market. Our clients, as buyers – are having a hard time buying things in the billion dollar plus range because of intense competition.

The multiples in the mid-market deals are a bit lower, and I think the markets are a bit less efficient, which creates opportunities.

Trade sales saw a big increase in 2014 – has this been the case this year? Why/why not?

We focus on tech, and within tech the market is a tale of two cities. On the one hand you have companies that are fast growing high fliers, which seem to have unlimited opportunity to access private markets and public markets. These firms generate the most consistent interest from strategic buyers. This was the case in 2014 and a large
part of 2015, although this year you are seeing that there has been more bifurcation between high-quality, high-growth stories that get lots of interest and strategic demand and some lower-quality businesses that have not ended up trading.

It’s really four or five different factors behind the record trade sales last year. As mentioned, strategics have lots of cash on their balance sheets. They have had little opportunity to put it to work. Many of them resized and restructured after the financial crisis, and are now in a place where they can operate very efficiently. However, there is no place to put the cash. Trade sale multiples are up this year even compared to last year, going from close to nine to close to ten. But even for those multiples of EBITDA, if you translate this into earnings-per-share multiples for the public companies, many of these deals are still accretive. And of course strategics can squeeze out a lot more value out of a target company than a financial buyer can because of the overlap of operational capabilities.

More importantly, the strategic buyers need growth, and there aren’t many places to get it other than to buy it. It’s probably a little bit of ‘what are we going to do with the money, how will we show shareholders we’re growing?’ And they’re doing two things with it. One, they’re spending it on companies they can acquire, or they’re spending it on share buybacks. They’re trying to get earnings per share up one way or the other.

They gorge on these acquisitions for a few years and then realize how hard it is to tuck them in, make it work and how many pieces don’t fit. Then they spend a few years spinning them off and selling them. It’s just part of the cycle.

I think it’s still continuing to be the case. Whether that will continue to 2016 is a question, but right now things seem to be holding firm. People can get money, both public companies and LBO funds, to buy things that are highly leveraged. That’s going to continue to keep trade sales high for the course of the year, as long as the lending window stays open.

How are the IPO markets holding up for exits given recent uncertainty surrounding China and the western markets’ reactions?

It is probably too early to tell frankly. There is certainly a backlog of companies that are filed to go public or are filing and are looking to access public markets, but time will tell how that plays out. But I think it’s too soon to tell how the markets will react to some of those recent events.

The statistics show that the number of PE exits through IPOs is down this year. I think over 10% of PE exits were public offerings last year, this year I think it’s running around half of that. The big deals are still getting done – such as First Data and Albertsons, but the IPO window is not open for the smaller deals.
That being said, the statistics that I have seen indicate that PE exits as a percentage of all IPOs has remained constant at about 30%. It is just that the total number of public offerings is down.

I would say the IPO markets are, at best, tepid, and probably at worst, closed. Anybody that has gone public over the last couple of years I would say only one or two of them are trading at their IPO prices, most are trading at a discount. I would say the public markets have not been kind of late.

We now think that an adjustment is happening. Public markets certainly aren’t going to go away, but it’s just not a good exit at this point. Anyone who’s been thinking about an exit here is either going to have to wait or is thinking about alternative ways to exit.

I wouldn’t say they are dead. I think the IPO window is in a wait and see mode right now. I think if it stabilizes for a short time then we’ll see more IPOs again, particularly in the technology and life sciences sectors.

While there have been a few exceptions, most of the IPOs coming out are tech or life science focused both in the UK and US. These are less dependent on the overall health of the economy, but more based on the speculative nature of their technology. These IPOs are often unprofitable but their market potential has convinced analysts that Facebook, Google or Apple or someone else will gobble up – that’s what gauges these IPOs more than the general economy.

Ted Brandt, Marathon Capital
Are hold periods starting to come down due to it being a sellers’ market at the moment? Will this continue?

There are definitely some good examples of that. Especially in tech, given the strong macros of the last few years, investors have often had the opportunity today to take advantage of some quick wins that just weren’t possible in 2006 and 2007 – starting vintage funds. Given valuation multiples today, most businesses that were acquired in 2012 or even in 2013 that have grown reasonably well, are probably valued at a real premium compared to when those investors acquired the businesses. There are certainly some sellers that will take advantage of that opportunity to realize some quick wins.

By contrast, I think if you look at average hold periods for companies that have exited in the last year and a half, they’re probably relatively high. I say that because many funds have been selling portfolio companies that they’ve been holding for a long time, and are only now getting a chance to sell them.

I think as we move forward there will be some attempt to flip deals quickly, but when you buy at these higher prices it’s harder to flip quickly and make the kind of money you’d like to make. I would be surprised if you saw average hold periods coming down this year, because what’s being sold is so long in the tooth.

Well if you were somebody who built up a portfolio with the intention of a public exit strategy, now the public window is closed, you have a choice. You could quit acquiring assets and effectively milk the cow. You also could sell the assets, or you could raise more capital and bulk up to a larger portfolio with the hope of a public exit at some future point. I think everyone out in the marketplace is making one of those three choices.

I wouldn’t say hold periods have come down – a lot of these companies have been held for a number of years, as John says. What I am seeing though is that the buyers are tending to be the bigger private equity funds that are pushing down in the market to buy deals. For instance you might find a fund buying a $200m US deal, when before they wouldn’t go below US$300m-US$400m. They’re doing that with the idea of getting that company and using it as a platform to do other acquisitions. I don’t see people quick-flipping too much. A lot of the ones that are exiting – and there are a lot more exits than there are buys by most middle market funds these days – have been held for a number of years.

It’ll be interesting to see what will happen to the buyouts being done now. Will they be sold quickly? We’ll soon find that out, but I haven’t seen a lot of ‘turnaround and sell in a year’ deals as of late. Part of that is that the prices are so high today. People are paying huge multiples, they need to do growth and acquisitions to justify being able to sell it quickly.
What, if any, will be the biggest challenges facing exits in the coming year?

It is the macro environment. We have really had five years of stock markets that have largely been up and to the right, and the past month or so has brought real uncertainty. Buyers and sellers do come together a lot more often in stable markets than in very uncertain markets. That macro overlay is probably the biggest challenge risk which we will see play out over the next few months and into next year.

The challenge would be if a full blown recession came into China – or some other disruption that could cause buyers to be a lot more wary about paying these huge multiples for these deals. If the markets continue to be unstable or down trending, that could affect people’s confidence to do exits. Right now the confidence is still there, though.

There’s a number of things. First the financial markets are very skittish right now, and have been for a few weeks. If there’s a lot of uncertainty in the world, people will be less inclined to buy things, which will hurt on the sell-side. One of the problems you have after a big sellers’ market is that expectations no longer match on both sides of the equation. You get sellers who see statistics that show that their company should sell at a high multiple, and now all of a sudden there’s a contraction because of the industry, financial or worldwide instability. This means that, while a transaction might still be done at a very nice multiple, it doesn’t match the seller expectations. They think they aren’t getting a fair price.

Interest rates going up could certainly have an impact on the M&A activity although the trend has been for increasingly large equity checks, so the leverage component has been less of a driver – people just put more equity in to get the deal done.
At some point there may be less inventory of portfolio companies for sale, but if you look at the data there is still a very large backlog. If the strategics return to investing in organic growth, they might slow down their acquisitions, but that’s a trend that will take a couple of years to play out. I don’t think that’s a short-term driver.

In terms of the private exits, the biggest issue for US solar and wind businesses, is that they’ve been driven by very short term tax subsidies: wind by a production tax credit, and solar by an investment tax credit. Both subsidies are due to expire at the end of 2016. There seems to be some traction towards some potential legislative solution to that, but there’s no question that it’s very difficult to develop and run an appropriate business when public policy is uncertain and very short term.

The other impact it has is even though the subsidies are valuable, there’s a huge amount of friction that goes into monetizing them. Working against efficient financing. I would have thought the market would be much better off in the long run if the subsidies were to go away. But in the short run, primary volume will go down substantially.

Can this pace of exits continue? If so what will sustain it?

Well I thought it couldn’t continue for some time and I’ve been wrong for some time. I would say that this is an environment where the macro has dominated the micro and that will, determine whether the pace of exits continue.

It’ll be sustained by the factors we have been discussing and it will continue so long as they continue to fuel the fire. I don’t know which factors are driving it the most – or what would be the most damaging if it were to change. I can’t see interest rates going up a lot quickly, given what’s happened in the last few weeks. It’s hard to see strategics quickly changing their need to grow or running out of cash. It’s hard to see the PE firms not wanting to sell what they can.

Then again the world is a very fragile place. If we run into some kind of macro disruption, deal activity is often the first thing to grind to a halt. Some major political issue could stop activity just because much deal activity is driven by confidence and predictability of the future. If people don’t have confidence and don’t think the future is predictable they’re just going to sit and wait. And sitting and waiting is always bad for the deal business.

I actually believe that fundamentally, even though we’re at a time when oil is at an extremely low price, renewable power is very competitive. Solar wholesale is competitive, and wind wholesale is probably the lowest cost of electricity in America right now, particularly in the middle of the country. I do think that despite the subsidy uncertainty, you will continue to see a significant amount of
development, a significant amount of investment, a significant amount of competition for these assets for sale.

The reason I don’t is I think it can continue much longer (at least in the middle market) is that we’re starting to run out of good companies to exit, to be perfectly frank. A lot of PE funds have been selling off their portfolio companies but they haven’t done a lot of new buys given the high multiples. Eventually, you’re going to start to run out of quality deals as many middle market companies are acquired by larger buyers. The exit markets aren’t going away but the lack of attractive portfolio companies to sell seems like the biggest drag on exits.

When that exit pipeline dries up, I think we’ll see more public-to-public mergers or public acquisitions of large LBOs. There haven’t been as many big public-to-public mergers in recent years, but there will be more pressure to increase that option as private opportunities become more difficult to find.

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For more information, please contact one of the following Toppan Vite representatives:

**Glen Buchbaum**  
Senior Vice President of Sales  
GlenBuchbaum@toppanlf.com  
201.518.9720

**Bill Lee**  
Senior Vice President of Sales  
BillLee@toppanlf.com  
212.596.7769

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