Deal Flow & Valuations Chart Separate Paths

The pace of dealmaking slowed, while valuations are on track to hit a new peak in 2017, reflecting sponsors' rekindled focus on quality

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Dan DiDomenico, a Senior Managing Director, joined Murray Devine in 1995 and his responsibilities include the day-to-day management of valuation and financial opinion engagements. Prior to joining Murray Devine, Dan was a Senior Financial and Operations Auditor with United Technologies Corporation, and was also a member of the internal audit staffs of Bethlehem Steel Corporation and Foster Wheeler Corporation. Dan received a Bachelor of Science degree in Business Administration and a Masters in Business Administration from Drexel University's Bennett S. LeBow School of Business. Dan is also a Certified Public Accountant (CPA) with an Accreditation in Business Valuation (ABV) and holds the designation of Chartered Financial Analyst (CFA).

Halfway through the year, how would you assess the impact of any uncertainty related to government policies thus far, and what do you see moving forward?

In general, PE firms are definitely keeping track of what's going on in Washington, but the absence of any real movement around President Trump's proposed policy agenda has kept investors focused on other variables. The economic picture and business fundamentals, in particular, remain strong. And while we saw that the Fed remains intent on normalizing monetary policy, with quarter-point hikes in March and June, rates remain near historic lows.

That said, activity was slightly down in 2Q when looking at both the aggregate transaction value and volume. At this point in the year, it could be difficult to reach the level of new deal activity experienced over the past three years without some kind of tailwind from Washington, whether it's tax reform, an infrastructure program or, potentially, something else. In April, the president provided some color around his proposal for tax reform. The promise of a tax holiday on overseas cash, for instance, would be exactly the type of catalyst that could reintroduce some momentum, even if it's in the form of exit activity.

On a sector-by-sector basis, a lot of investors are also looking at potential trade policies. To nobody's surprise, the administration pulled out of the Trans-Pacific Partnership earlier this year, and the talks around the Transatlantic Trade and Investment Partnership have seemingly stalled as of the end of 2Q. As the protectionist rhetoric seems to build, others are stepping in to fill the void. The Japan-EU trade pact is one example that could impact industries ranging from agricultural products to industrial goods and even autos. Talks of tariffs could entice some investors. Let's not forget that Wilbur Ross, Trump's current Commerce Secretary, benefitted handsomely when President George Bush imposed a 30% tariff on steel as his firm was building out International Steel Group, one of his landmark deals.

Building upon the activity you're seeing in various sectors, were there any major takeaways from the first half of the year as it relates to activity in particular industries and where do you foresee more opportunities, relatively speaking, for PE buyers?

You did see activity start to ebb and flow in certain industries. The backdrop of falling oil and gas prices, for instance, led to a precipitous drop-off in investments in the energy sector. There may be some distressed opportunities available, but it's tough to make the numbers work when oil prices remain in the low $40 range. Still, this is when you begin to see some opportunistic buyers swoop in. Berkshire Hathaway's $18 billion deal in the first week of July to acquire Oncor—part of the bankrupt Energy Future Holdings—is one example. That was formerly part of PE-backed TXU, which went bankrupt when natural gas prices fell.

Elsewhere, and on a more positive note, the technology sector has been generating a lot of interest. Last year, proportionally, we saw a big uptick in the number of technology investments, and sponsors are building on that momentum here in 2017. In the first half of the year, nearly one out of every five PE investments have been in the technology sector.

There are a lot of factors at play when it comes to this trend. For one, a number of firms have developed specializations in the sector over the past few years. Sponsors have recognized for a while now that a secular shift is occurring and they've since built up the expertise to understand where the opportunities reside and how they can add value.

The second factor is technology creeping into every other sector—effectively, every company has to reimagine themselves as a digital company today. GE runs a cloud platform; restaurants are replacing cashiers with kiosks and mobile apps; even financial services companies are confronting what new technical advances will mean for their business. In June, a Bloomberg article covered Goldman Sachs' efforts to automate certain functions within investment banking. This trend literally touches everybody, and is creating some great opportunities for investors to help orchestrate this change. Sponsors are finding opportunities in areas of the market that may need some help progressing along the technology curve. This requires capital investments and a strategic vision, so it's an area where material value can be added.

Given the struggle of some notable names in tech-disrupted retail, do you anticipate investors will remain interested in retail?

Over the past decade, there has been something of a pullback as it relates to deals in the broader consumer space, and this has been even more pronounced in 1H 2017. This was always a favorite area for a lot of PE firms, so the level of activity today is aligned with what you'd see in other sectors.

Coming out of the financial crisis, you saw a lot of firms bet on the resiliency of the consumer and many of those deals paid off for both GPs and their limited partners. More recently, though, the secular shift in consumer shopping patterns has had a sizable impact. There have been quite a few bankruptcies, leaving both lenders and equity sponsors a bit gun-shy.

In terms of the nature of the activity, changes to the bankruptcy law limit the amount of time for investors to coordinate a restructuring, so you're seeing more liquidations in this recent run of bankruptcies. But sponsors are keen to find value where they can and are open to helping retailers navigate this period of uncertainty. The $6.9 billion buyout of Staples, for instance, will see Sycamore Partners basically split the company into three businesses and engineer growth strategies that are focused on the core competencies of each. Elsewhere, much of the attention has been on "experiential" offerings for consumers. The acquisition of Blue Man Group by TPG-backed Cirque du Soleil, for instance, seems to tap into that trend.

One thing that we haven't talked about is the Amazon effect. The announced acquisition of Whole Foods was symbolic of Amazon's encroachment in just about all consumer-facing segments of the market. GPs, in their due diligence around retail-oriented businesses, are hyperaware of this threat and will ask themselves what percentage of the revenue stream might be exposed to Amazon. It's one of the reasons so many investors are focused on the consumer "experience" when it comes to retail, because that can provide a bit of a moat.

On other side of the coin, though, sponsors are also exploring how they can help companies compete against this threat. Worldpay, formerly backed by Advent International and Bain Capital, recently merged with Vantiv in a $10 billion deal that creates a giant in the payment processing and technology services space.

Despite all of these different dynamics, valuations remain extremely high at 12x EBITDA. How are PE fund managers mitigating current price levels?

Current valuations are related to the slowdown in activity we've witnessed in 1H. Sellers may not be willing to give up much in the way of price coming off of a peak in the cycle, while buyers are definitely becoming more discriminating. As a result, the deals that are getting done are primarily high-quality assets that can demand above-market valuations.

When you dig into the data, debt levels also climbed, so sponsors are confident enough to apply more leverage to make up some of the difference. I know in the small and middle market that we're also seeing sponsors pay up for assets that can provide a foundation for future rollups. So these investments are largely premised on realizing multiple expansion as the assets add scale through add-ons.

Ultimately, though, the way many are mitigating the high valuations is to merely step back and wait it out until the sellers come back with more reasonable expectations. That is one of the reasons behind the dispersion between deal volume and valuation trends.