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ATTORNEYS AT LAW

# INNOVATIONS @ HAND | PRIVATE EQUITY

## Connections IN THE MIDDLE MARKET

Spring 2011

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On the cusp of what many believe will be a major new cycle in middle market private equity, dramatic changes are apparent across the landscape: Many of the players have changed, deal structures have evolved, LP investment strategies are even more sophisticated, and there is new regulatory rigor, to name but a few. In this dynamic environment, we are pleased to introduce this new edition of *Connections*, our regular publication of leading-edge thought on the industry. Our intent with *Connections* is to focus, informatively and concisely, on the trends, issues and perspectives that are shaping middle market private equity, and which reflect the deeply knowledgeable views of significant players in the space. In this regard, we would particularly like to thank Seth Lehr of LLR Partners and Danny Rosenberg of Sterling Partners for their thoughtful observations, which greatly enrich our views.

A note on Duane Morris: With experienced private equity lawyers across our domestic and global platform, coupled with the deep capabilities of our full-service firm, 700 lawyers strong, we offer the resources to optimize transactional value; provide guidance on fund formation and exit strategies; and support and expand portfolio company operations. With our strategic focus on the middle market, broad experience in major industry sectors and an innovative culture deeply committed to client service, Duane Morris is regularly called upon to work with the most sophisticated and demanding players in the middle market.

Please accept this issue of *Connections* with our compliments. We intend to develop this publication with the input and advice of those in the industry whose collective experience is chronicled here, and we welcome your thoughts and comments.

George J. Nemphos
*Chair, Duane Morris Corporate Practice Group*

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## FAST FACTS

U.S. Private Equity Deal Flow in 2010: $132 BILLION invested in 1,498 deals
*PitchBook*

U.S. PE-Backed Exits in 2010: 480 with approximately 60% CORPORATE ACQUISITIONS
*PitchBook*

Average price of U.S. middle market transactions closed in 4Q 2010: 6.1X TRAILING 12 MONTHS EBITDA
*GF Data Resources*

# Where We've Been;
# **Where We're Headed**

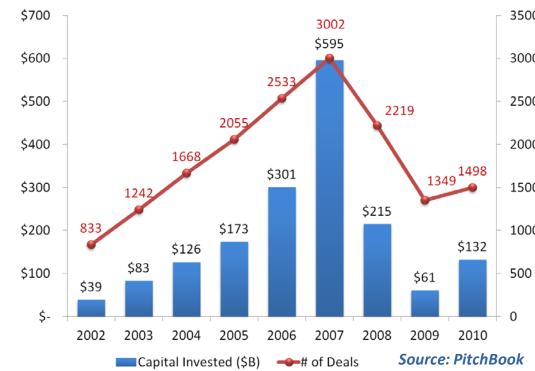
After experiencing a severe downturn, the private equity industry is poised for a rebound. The downturn followed an unprecedented boom, as low interest rates, plentiful debt and investor capital fueled the asset class' "golden age" from 2002 to 2007. Beginning in 2007, the global credit crisis caused a sharp falloff in deal activity. U.S. private equity deal flow fell from a peak of $595 billion in 2007 to $61 billion in 2009, but with the strengthening economy, rebounded to $132 billion in 2010 (*see Chart 1*).[1] Similarly, U.S. private equity fundraising dropped from $262 billion in 2007 to a low of $84 billion in 2010.[2] As the industry entered 2011, signs of recovery could be spotted, as deal activity and fundraising began to pick up.

Despite tremendous challenges ahead, such as refinancing roughly $250 billion in debt coming due in the next five years and deploying nearly the same amount in "dry powder," private equity's proven business model for value creation is compelling. Research has shown that in the first two years after a private equity transaction closes, portfolio company productivity grows by about two percentage points—more, on average, than in similar public firms.[3] Industries in which PE funds have been active in the past five years have grown more rapidly than other industries, whether measured by total production, value added or employment.[4]

Steven Kaplan at the University of Chicago's Booth School of Business points out that, relative to other asset classes, the duration of private equity's capital "matches the duration of its assets—that is, long-term capital making long-term investments."[5] This also means that the time horizon of private equity looks beyond the quarterly focus of many public companies. Indeed, research shows that private equity contributes to robust long-term investments in innovation, as measured by patent citations, and innovation becomes more targeted post-investment.[6]

Although hurdles persist, middle market private equity's growing track record of realizing significant operating improvements and returning capital to investors is gaining in acceptance as a standard tool for transforming companies. Defined as transactions with enterprise values of $10 million to $250 million, middle market PE does not attract the media coverage of mega-market deals.

## CHART 1
### U.S. PRIVATE EQUITY DEAL FLOW BY YEAR



“**Markets are back in a very strong way,** and debt financing, either through traditional senior lending or subordinated mezzanine lending, or public debt, is about as strong as it has ever been and priced very, very effectively.”

*Seth Lehr, LLR Partners*

Yet, deals from the middle market represent the most significant part of the dealmaking landscape. To help size the middle market properly, at its 2007 peak, all private equity accounted for nearly a fourth of all global M&A transactions. Of that universe, the large majority of transactions represented private-to-private deals involving entrepreneurs and family businesses turning to PE firms for growth capital. In 2010, deals under $250 million made up 70% of the deal flow.[7]

A few indicators are pointing to a recovering middle market. For instance, as Seth Lehr of LLR Partners observes: “Markets are back in a very strong way, and debt financing, either through traditional senior lending or subordinated mezzanine lending, or public debt, is about as strong as it has ever been and priced very, very effectively.” “The debt market has come roaring back,” notes Danny Rosenberg of Sterling Partners. This view is supported by growing debt and falling equity contributions in middle market deals from 2009 to 2010 (*see Chart 2*).

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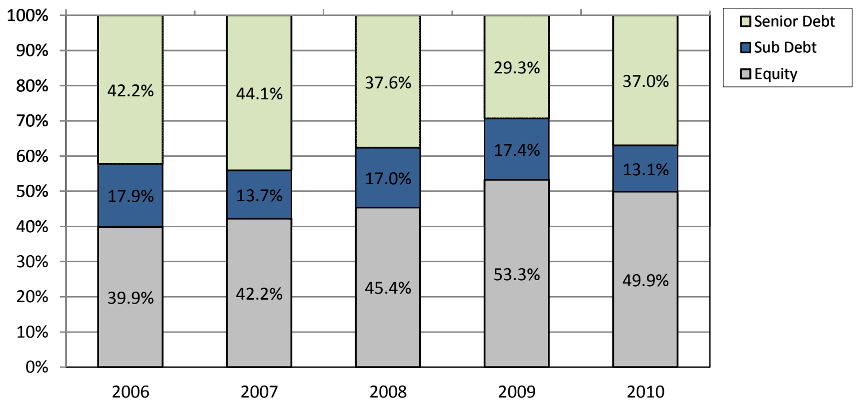
As PE recovers from the downturn, there are many questions about the pace, longevity, and deal-structuring details of the next phase of the cycle. In the following pages, we explore five key trends that we see shaping the industry's future.

"The debt market **has come roaring back.**"

*Danny Rosenberg, Sterling Partners*

## CHART 2
## EQUITY AND DEBT CONTRIBUTIONS




*Source: GF Data Resources*

# 1. Middle Market Private Equity Is **Alive and Growing Stronger**

Some commentators predicted that the private equity industry would be hard hit by the financial crisis. For example, Boston Consulting Group opined that 50% of PE portfolio companies would default and 40% of buyout groups would "shutter their operations."[8] The facts belie these observations. Although many PE groups had to downsize and in some cases even return capital to investors, the asset class generally did a better job of weathering the "Great Recession" than hedge funds—which were hit by more than $500 billion in redemptions. Moody's opined that buyout firms' "access to capital, strong relationships within the capital markets, and financial sophistication" can improve recoveries for creditors; in fact, Moody's expected "creditors in distressed companies backed by private equity to fare comparatively well."[9]

### MIDDLE MARKET PRIVATE EQUITY—THE REAL GROWTH CAPITAL

Key to the strength of PE in general, but middle market PE in particular, is proactive engagement with its portfolio companies. In many cases, these portfolio companies were in a strong position to withstand the downturn, and middle market PE funds could take advantage of the market to buy weaker companies. LLR Partners, a middle market PE fund, has evolved by aggregating expertise in certain business services sectors and adding operating partners, a strategy that provides middle market PE "a more interesting entry price based on the lack of a fully formed business," notes Lehr.

Other portfolio companies thrived due to the PE firm's deep knowledge of the sector in which it invests, as well as hands-on operational experience. The value of having deep sector knowledge is that it enables PE firms to understand the nuances of the operations of those markets, as Rosenberg emphasizes: "where are the opportunities, where can you develop and build businesses that have defensible positions, where you see good growth prospects, where you can attract experienced management and where you understand regulatory opportunities."

Some PE groups with capital and economically strong portfolio companies, which required less attention and resources, were in a position to make great acquisitions. For example, in 2010, LLR took advantage of what Lehr calls a "very messy market" and "aggregated assets at a very effective cost basis to grow [its] business" and made a record number of investments. Moreover, the greatest lesson learned from the downturn, according to Lehr, is that "capital is king. Access to capital is really what allows you to survive difficult periods."

"Where are the opportunities, where can you develop and build businesses that have defensible positions, where you see good growth prospects, where you can attract experienced management and ***where you understand regulatory opportunities.***"

*Danny Rosenberg, Sterling Partners*

"**Capital is king.** Access to capital is really what allows you to survive difficult periods."

*Seth Lehr, LLR Partners*

"We had a bunch of liquidity events last year. **The right companies, with the right management and the right business model…will sell for a good price in any market."**

*Danny Rosenberg, Sterling Partners*

A key barometer of the industry's health is the market for exits. Thanks to an improving economy and a more vibrant stock market, exits are growing. Exits were up 3.8x from the low of 39 during 1Q 2009 to 148 in 4Q 2010 (*see Chart 3*).[10] Indeed, as Rosenberg notes: "We had a bunch of liquidity events last year. The right companies, with the right management and the right business mode…will sell for a good price in any market." These liquidity events are critical to the business—they provide a measure of PE's value creation capacity and the capital necessary for LPs to reinvest in new funds. Last year saw a growing trend of secondary transactions—PE to PE sales—driven by significant overhang of PE capital that needed to go to work before the end of the fund's life. Middle market PE firms also play an important role in strengthening companies that larger funds with more capital and bigger platforms can better take to the next stage of development. Many of LLR's exits in 2010 were to PE firms—a trend that Lehr says shows that "every PE firm has its point of entry in the life of a business."

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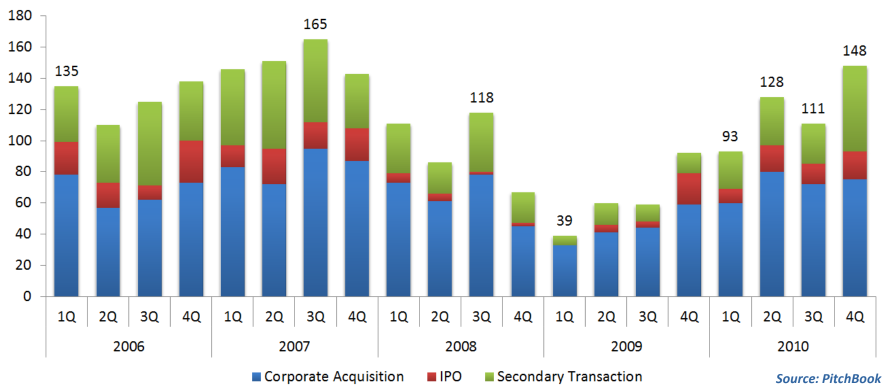
## CHART 3

## U.S. PRIVATE EQUITY EXIT ACTIVITY




*Source: PitchBook*

### FAST FACTS

U.S. PE funds raised in 2010:
$84 BILLION
*PitchBook*

U.S. PE transactions in 2010:
1,498
*PitchBook*

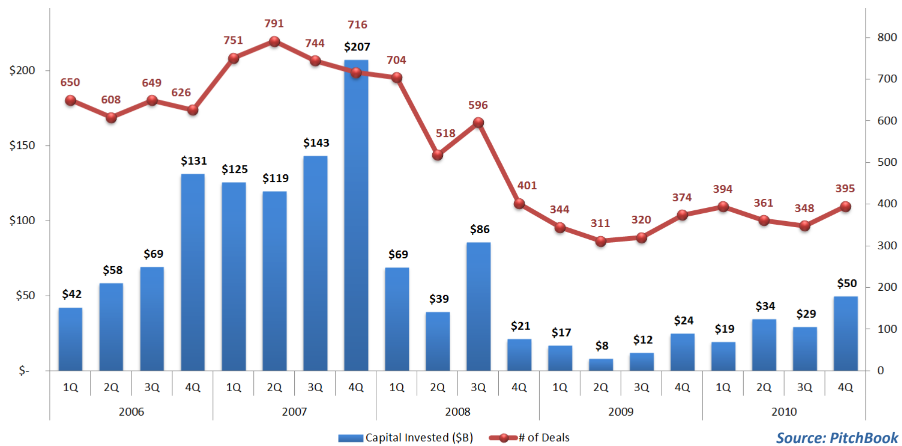
Middle market share of total M&A by dollar volume in 2010:
17%
*Accordion Partners*

## 2. **Investor Profile Is Diversifying—** Now More Discerning, Gaining Bargaining Power—***Will This Strengthen the Asset Class Going Forward?***

Tough domestic fundraising conditions over the past several years forced GPs to look abroad as existing investors and many U.S. pension funds and endowments retrenched. Consequently, GPs made more trips to Europe, and increasingly more to the Middle East and Asia. Per Danny Rosenberg: "As in any business, it is important to expand and diversify your customer base." In addition, the investor base is becoming more sophisticated, as Sovereign Wealth Funds and family offices join the early pioneering institutional investor class of PE groups.

Although middle market funds claimed almost 90% of the total PE capital raised in 2010,[11] the economic downturn slowed fundraising significantly to a six-year record low. In the U.S. market, only $10 billion in capital was raised in Q4 2010, compared to the nearly $110 billion raised during the boom's peak in Q2 2008[12] (*see Chart 4*). Rosenberg characterizes today's environment as a flight to quality—investors are reducing the number of GP relationships and gravitating to those firms "with strong, consistent track records, and a unique, differentiated and focused approach." Investors are drilling deeper, making more reference calls, in order to understand a PE firm's contribution to value creation. Many institutions "reevaluated their relationships and their commitments" and streamlined the number of funds they support.

## CHART 4
### U.S. PRIVATE EQUITY FUNDRAISING BY QUARTER




*Source: PitchBook*

Rosenberg characterizes today's environment as a flight to quality—investors are... gravitating to those firms **"with strong, consistent track records, and a unique, differentiated and focused approach."**

FAST FACTS

U.S. regions with greatest PE activity:
MOUNTAIN, MIDWEST, MID-ATLANTIC, SOUTH
*PitchBook 2011*

Average time spent fundraising by funds closed in 2010:
19 MONTHS, a 19% increase from 2009
*PitchBook 2011*

One of the more profound effects of the global economic downturn and its impact on fundraising is that bargaining power over terms and conditions shifted in LPs' favor. The establishment of the International Limited Partners Association (ILPA) and its September 2009 first draft "Private Equity Principles" to promote alignment of interests, enhance governance and improve transparency were signs that the pendulum might have swung too far in the GPs' direction. Although there has been no drastic shift in terms and conditions, LPs have in some cases been able to reduce management fees below 2%, share more transaction and monitoring fees and implement stronger clawback provisions.

At the same time, many middle market PE firms have long operated with LP-friendly terms. LLR "doesn't charge portfolio companies deal fees [or] quarterly monitoring fees." LLR, says Lehr, has "always thought that we should have full alignment with management of our portfolio companies, DuaneMorris®

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and that creating fee structures [fosters] a lack of alignment...allowing some to make money when others may not be. This is true for both our portfolio companies and our investors/LPs." By strengthening the private equity partnership—the alignment of interests between LPs and GPs—this recalibration in the balance of power may be in the asset class' longer-term interest.

Key to the sustainability of the LP-GP partnership is communication and consistency. "Clear, consistent, transparent communication with our management team and limited partners was critical to getting through the crisis. What really supports this approach is consistency of team...all our founders are still here," says Lehr of LLR Partners.

FAST FACTS

Largest U.S. PE investments by industry: MATERIALS & RESOURCES, FINANCIAL SERVICES, B2B, AND HEALTHCARE

*PitchBook 2011*

Number of funds currently on fundraising trail: 660

*PitchBook 2011*

# 3. Increasing Scrutiny Portends **More Regulation and Higher Operating Costs**

Private equity's success and visibility have attracted increased government scrutiny, a by-product of negative public perceptions precipitated by fraud and abuse in some other parts of the financial services industry. As a corollary, high-profile deals involving brand name company targets and the industry's alleged veil of secrecy have increased vulnerability to adverse publicity and reputational risk. In part, much of this can be traced to the general lack of understanding of the mechanics and economically beneficial results of the asset class—a theme now being addressed by the ACG's Middle Market Private Capital Leadership Forum, the Private Equity Growth Capital Council and the World Economic Forum, among others.

Greater government intervention is a distinct trend that the financial crisis has only accelerated. In the U.S., the Dodd-Frank legislation will require banks to shed their PE operations and thus should encourage spin-outs. Although few commentators believe these captive arrangements contributed to systemic risk in the financial system, direct access to credit was believed to encourage excessive dealmaking. Also under the new legislation, PE groups (other than SBICs and venture funds) with more than $150 million in assets under management must register as investment advisers with the Securities and Exchange Commission. A BNY Mellon and PEI report last year found that GPs and LPs believed that registration would be "burdensome and unnecessary, especially for smaller firms that pose no risk to the financial system and may lack the resources to set up compliance programs."[13] The new Basel III regulatory capital requirements and the EU's Alternative Investment Fund Manager Directive will entail even more demanding requirements, with the latter expected to increase fundraising costs for U.S. GPs. An outstanding question surrounds proposals to increase the 15% capital gains tax on carried interest to something approaching the maximum rate on ordinary income of 39%.

PE's growing prominence—the industry owns nearly 6,000 U.S. firms, up from 1,620 in 2003,[14] and employs more than six million Americans[15]—suggests that the asset class is likely to attract even more scrutiny, not only from LPs, but also from the government and the media. Government regulation in particular will tend to raise operating costs and hit smaller PE firms disproportionately. Thus, increased regulation and oversight will test the PE business model and conceivably impede the industry's underlying entrepreneurial dynamic.

## FAST FACTS

Number of U.S. PE groups managing more than $1 billion:
250
*This represents 85% of the U.S. industry's assets, SEC estimate*

Percent of LPs that have net returns of 16% or more:
22 PERCENT
–compared with well over a third in summer 2009
*Coller Capital Summer 2010 Barometer*

Percent of equity used in U.S. buyout deals under $1 billion (2010):
43 PERCENT
*PitchBook*

Rate of job growth above industry average at new U.S. facilities built by portfolio companies:
6 PERCENT
*World Economic Forum*

# 4. As Competition Increases, PE Groups Will Be Challenged to **Innovate and Create Value**

The economic downturn not only put pressure on weaker PE firms but also created formidable barriers to entry for new PE groups. Unlike other industries, private equity tends to exhibit "barriers to exit," as investor capital is locked in over seven to 10 years. Rosenberg predicts "we are clearly going to see a shakeout in the industry over time, but it will take a while to play out." Relatively low entry and high exit barriers suggest intense competition and an increasingly difficult market for GPs to replicate the stellar returns of the past. Lehr sees this as one of the big questions going forward—"whether the great returns that have been enjoyed over many years will be a historical perspective and not expected in the future."

A stark indicator of the impact of the financial crisis is the first ever contraction in the number of PE firms over the past year. In 2010 there were approximately 4,130 active fund managers globally, down from 4,180 in 2009.[16] This is a function of both a significant number of firms becoming inactive (identified as not having raised a fund in the past 10 years) and fewer new firms entering the industry.

Amplifying existing competition within the PE industry is the burgeoning entrée of "big company" internal PE units' investments in portfolio companies as future acquisition targets—almost an outsourcing model. One recent example is the decision of a global manufacturer of digital imaging and business solutions to invest in a PE-funded medical imaging company, and there are many others. Clearly, this is a hedge for major companies in terms of technology procurement costs and innovation.

## PE FIRMS' VALUE-ADD: BEST MANAGEMENT PRACTICES

Under today's highly competitive conditions, GPs will likely respond by becoming more innovative around the financial, operational and governance drivers of their businesses. Despite the media's negative portrayal of financial engineering, GPs' ability to access debt and equity markets proved essential to surviving the financial crisis and will remain so in transforming their portfolio companies and finding lucrative exits. These core competencies have become even more critical given competitive pressures, the economic slowdown, and the natural tendency for GPs to specialize by taking advantage of "operational partners" such as ex-CEOs with deep industry knowledge. Operational partners play many roles at middle market PE firms who rely on them—from director or interim chairman to consultant or CEO. "In addition to the value they add in helping with oversight and management of our portfolio companies, they [provide] great intelligence on the front end from a diligence standpoint," says Rosenberg of Sterling Partners. Founded by entrepreneurs, Sterling has a "very hands-on operational approach," with half of its team focused on operations, he adds.

**FAST FACTS**

Number of PE firms worldwide (2010):
4,130
*Preqin*

Number of years PE firms hold onto portfolio companies on average:
5
*World Economic Forum*

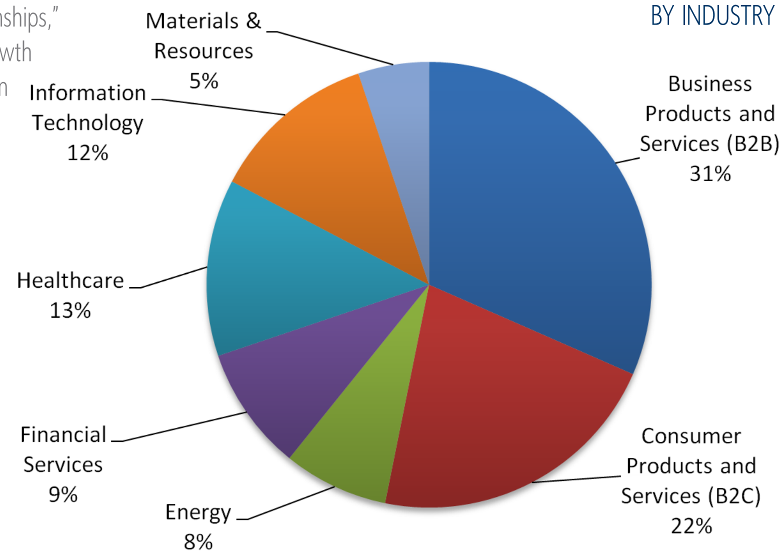
## 5. The Private Equity Industry **Will Continue to Transform Itself** in Terms of Scope, Size, Strategies and Industry and Geographic Focus

A telling sign of the vitality of the private equity model is its ability to enter new sectors and geographic regions, as well as to combine with other organizational forms and alternative asset strategies. As a result, the industry is highly fragmented. Driven by competition and the model's success in aligning investor and GP interests, this evolutionary process is likely to continue transformation of the industry toward both greater specialization and diversification over time.

As became apparent during the boom years in the last cycle, a number of established PE groups were able to raise multibillion-dollar mega-funds, enabling them to target larger and larger companies—particularly when combined with other PE firms in "club deals." Yet at the other end of the market, smaller funds continue to enter the business and target the middle market. The 10 largest PE firms accounted for roughly 15% of all funds raised in the last 10 years; the top 100 account for about 45%.[17] Diversification characterizes the strategy of some of the mega-firms (such as Blackstone, Carlyle Group and KKR), which combine their PE operations with alternative asset and investment banking practices, then go public, and leverage their brands to become global asset management players.

In addition to expanding geographically, especially to Asia, PE groups are becoming more industry-specialized. Ahead of this trend, Sterling Partners has always chosen to focus its portfolio on a couple of key industries, particularly education and healthcare services, thereby leveraging "industry know-how, knowledge, experience and relationships," says Rosenberg of Sterling. Healthcare is especially seeing tremendous growth in PE participation, so much so that in May 2010, an industry association was created to support "the reputation, knowledge and relationships of the healthcare private equity community."[18] In other concentrations, business services and consumer products and services are attracting more than 50% of deal flow. (*See Chart 5.*)

CHART 5
PRIVATE EQUITY INVESTMENTS BY INDUSTRY




*Source: PitchBook*

# Prediction

Given its focus on providing capital to entrepreneurs and small growing companies, middle market private equity will likely penetrate more deeply into the "real economy," precipitating more dramatic and positive impact on a growing number of industries and regions.

“One of the things that we enjoy every day in our business is the ability to work with entrepreneurs who think of very creative ways of satisfying a need that exists in the market and helping them aggregate the assets they need—human, financial and otherwise—to execute on their vision. **And that happens every day.**”

*Seth Lehr, LLR Partners*

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Seth Lehr, a founding Partner of LLR Partners, a Philadelphia-based private equity fund with $1.4 billion under management, has over 20 years of private equity experience. LLR invests in middle market growth companies, focusing on a broad range of industries, with an emphasis on business, financial, healthcare and consumer services and software and information technology.

Seth is a senior member of the firm's Education practice and is responsible for a number of investments in Outsourced Business Services and Consumer Services. He is also a member of the firm's Investment Committee. Seth currently serves on the Boards of Brightside Academy, Community Education Centers, The Reading Group, Regency Beauty Institute and Avenues: The World School.

Prior to LLR, Seth was Managing Director and group head of the investment banking division of Legg Mason. He began his career in investment banking at First Boston and Lehman Brothers.

Seth holds a BS in Economics from the University of Pennsylvania and an MBA from the Wharton School of the University of Pennsylvania.

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Through his 20 years of experience investing in alternative assets, Danny Rosenberg has gained insights into the needs of Sterling Partners' LPs and portfolio company managers, and he has applied an outcomes-driven and customer-first approach to portfolio and relationship management. Danny plays a key role in building teams that leverage best practices across the Sterling network to accelerate growth, including managing the Sterling Accelerator Program, which places high-potential young professionals into Sterling's portfolio companies. Danny's investment interests and experience span the healthcare services, education and business services industry sectors.

Danny's background in operations, finance and strategy stem from his experience with growth companies, investment banking and institutional investment organizations. Before joining Sterling Partners in 1999, Danny was an Investment Banker at Vector Securities International, a healthcare-focused investment bank. He also served as a Vice President of Acquisitions at Heitman Financial, an institutional investor in commercial real estate. Danny received his MBA from Kellogg School of Management and his BA from Duke University.

Sterling Partners is a leading private equity firm with over 25 years of experience partnering with entrepreneurs to build market-leading businesses and generate superior returns. With approximately $4 billion of assets under management, Sterling invests growth capital in industries with positive, long-term trends and provides ongoing support to management through a dedicated team of industry veterans, operators, strategy experts and human capital professionals. Sterling Partners is a leader in education, healthcare and business services and is co-headquartered in Chicago and Baltimore.

[1] PitchBook, *Annual Private Equity Breakdown 2011* at 3 (2011).
[2] *Id.* at 12.
[3] World Economic Forum, *The Global Impact of Private Equity Report* at viii (2010).
[4] *Id.* at ix.
[5] Steven N. Kaplan, Entrepreneurship Research at Chicago Booth, *Capital Ideas* at 1 (October 2009).
[6] World Economic Forum, *The Global Economic Impact of Private Equity Report 2008* at ix (January 2008).
[7] PitchBook, *Annual Private Equity Breakdown 2011* at 5 (2011).
[8] Boston Consulting Group, *Get Ready for the Private-Equity Shakeout* (December 2008).
[9] Moody's, *Private Equity 2009, Nearly Half of Defaults, but Better-Than-Average Recovery Prospects*, Special Comment, at 1 (March 2010).
[10] PitchBook, *Annual Private Equity Breakdown 2011* at 11 (2011).
[11] PitchBook, *Annual Private Equity Breakdown 2011* at 12 (2011).
[12] *Id.*
[13] BNY Mellon and PEI Media, *Private Equity Faces the Future: Candid Views from the Market* at 20 (May 2010).
[14] PitchBook, *Annual Private Equity Breakdown* at 3 (2011).
[15] Private Equity Growth Capital Council, *PE by the Numbers* (2011) (www.pegcc.org).
[16] Preqin, *Private Equity Spotlight* at 6 (January 2011).
[17] Bain & Company, *Global Private Equity Report* at 20 (2010).
[18] Healthcare Private Equity Association (www.hcpea.org).