Where's the Deal Flow? (First of a Series)

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With the first quarter of 2016 in the books, we kick off the second with a look at our *Chart of the Week*. Our content partners at Thomson Reuters LPC report middle market activity with sponsors slumped to $7.3 billion – the lowest level since 2010.

Anecdotally mid cap lenders confirm this trend. "We're pretty slow right now," said one regular player in the space. "It's quiet out there," agreed another. "And the stuff we're seeing isn't that interesting. Deal quality has definitely deteriorated."

Yet in recent meetings with top-tier private equity firms, a more upbeat view emerges. "We're seeing a record number of books this year," a managing partner told us. "January and February are historically slow," he said, "but not this year. There's a lot of very aggressive bidding going on. But it does include some class B properties."

This inflow of confidential information memoranda doesn't always translate into meetings with potential sellers. "It's not a question of stuff coming over the transom," one PE principal said. "There's plenty of that. The real question is, do you have an angle? Huge premiums are being paid out there. Can you compete at those levels?"

Another sponsor agreed. "If a firm isn't willing to get on the treadmill and grind it out on a bunch of auctions, you're just not that busy right now. Valuations between buyers and sellers still aren't aligned."

Among some veteran investors, we've heard a more nuanced approach. "Our firm has made five acquisitions so far this year, and all of them were proprietary," a long-time partner reported. "But our deal origination process has been developed over three decades. We don't rely on auctions, so our pipeline is much less volatile."

He went on. "Mining truly proprietary opportunities is extremely hard work. Our operating partners and management teams with decades of experience spend a ton of time sorting through hundreds of businesses. That model is less affected by cycles."

Not all PE investors are as sanguine about the economic backdrop. "Let's face it," a leading midcap sponsor told us, "the economy is not growing and financing markets aren't particularly stable. That makes us cautious. Are we active buyers? Absolutely. But current supply/demand dynamics won't change until real supply comes to market."

Are sponsors more active sellers than buyers in this market, we wondered, unloading (as one PE chief memorably put it) everything that isn't nailed down? "That depends on where you are with your fund life," was one answer. "In our case we took advantage of favorable purchase price multiples last year, and had excellent realizations."

Over the next few weeks, we'll examine in more detail how both sponsors and key middle market lenders are viewing deal supply for the coming quarter, and whether (as we believe) things are not quite as bad as statistics seem to show.