

## Private Equity/LBO News

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### Higher Prices Put The Squeeze On Private Equity Middle Market

Matthew Craft, April 8, 2005

Private equity (PE) deal ticket sizes are shooting up in the middle-market segment. In the last quarter average deals jumped from \$175 million to \$269 million against last year, according to Dealogic, and that's right in the wheelhouse for middle market PE firms. The knock-on effect is that returns are getting squeezed.

"I've long argued that, eventually, private equity will bifurcate," said Josh Lerner, Jacob H. Schiff professor of investment banking at Harvard Business School, adding he wouldn't be surprised if some middle market firms close their doors. Lerner, who's working on a study of private equity returns, said in the '80s and '90s small and middle market firms often scored better returns than the larger buyouts, which lacked proprietary deal flow and fought over companies at auctions. "In the last couple of years, there's been a sort of flip," Lerner said. As prices have edged up, forecast return targets have come down. A decade ago, firms used a target of 25-30% as a hurdle rate before they invested. "Now you see groups using hurdle rates of 17%," he said.

**The inefficiencies of the middle market disappeared as more firms piled in, said Mitchell Hollin a partner at LLR Partners, which recently closed a \$360 million fund. Good deals are harder to find. In response, LLR makes a point of avoiding auctions, focuses on the mid-Atlantic region and specializes in a few sectors. About 90% of the firm's deals are proprietary and 80% are within a two-hour drive of its Philadelphia offices. "To get above-average returns in the private equity world takes a differentiated strategy," he said, noting that LLR shoots for returns approaching 30%. "Those that try to be all things to all people are destined to have inferior returns."**

Lerner speculated one reason larger funds have more attractive returns is through club deals while middle market firms are still bidding solo. Five years ago, the second round of auctions for middle-market deals might have included five firms, bankers say. Now, maybe 10 make it to the second round.

"Beyond a shadow of a doubt, there are more firms than there used to be," said Justin Abelow, a director at the investment bank of Houlihan Lokey Howard & Zuckin. The auction process might push up prices, but it also forces firms to do more than just use leverage. Private equity firms are now focusing on operations.

"A banker is making an efficient market," Abelow said. "Blaming bankers for higher prices is like blaming the stock market for high stock prices."