



“SERVICE FIRMS ARE TOO TOUGH TO FINANCE BECAUSE THE BANKS ARE NOT USED TO THEM. THE BANKING MODEL HAS NOT SHIFTED — CASH-FLOW LOANS ARE TOUGH. — Justin Blaine

Justin Blaine, managing director at Mentor Group, a Westlake Village investment bank and financial advisory firm, said aerospace and defense companies remain popular with private investors for their long-term contracts whether they are engineering firms that work with Boeing Co. and Northrop Grumman Corp. or they do specialty machining for General Electric (jet engines).

“That is a huge sector throughout Southern California obviously,” he added.

Blaine noted one factor behind the appetite for private equity financing deals is the weak lending from banks to the types of companies that are proliferating. There is a tidal shift in the economy toward service providers such as digital advertising firms and away from manufacturing, which uses asset-based loans.

“Those service firms are too tough to finance because the banks are not used to them,” he said. “The banking model has not shifted — cash-flow loans are tough.”

#### ‘Dollars chasing deals’

Bonrouhi’s firm has a strong pipeline of deals featuring lower middle market companies in the \$10 million to \$100 million revenue range.

For entrepreneurs, it’s a good time to sell, and there are plenty of private equity funds and strategic buyers with money.

“Today, the lower middle market is the strongest segment of the overall middle market in terms of private equity,” Bonrouhi said.

Greg Bennett, owner at Lionfish Advisors, a boutique investment bank in Los Angeles, also works on the lower end of the middle market with deals between \$5 million and \$50 million. He believes that what is true for his firm is true for the rest of the market in that activity is heavy because of demand to put money to work.

“It is competitive at the bottom because there are a lot of dollars chasing deals,” Bennett said.

Matt Crowley, an attorney that works on investment banking deals at his firm Crowley Corporate Legal Strategy in Encino, said private equity acquirers tend to seek companies that are under the radar.

If they do the deal right, a firm can make a killing off of those kinds of companies and find there is no competition in trying to acquire or get a majority stake in them, he said.

“Think of something as unsexy as a third-party administrator for health insurance,” Crowley explained. “Private equity likes that kind of thing.”

The number of deals that an investment bank closes in a year typically is not large. Calabasas Capital, for instance, had only two deals in 2016.

A survey by PitchBook, a Seattle firm that tracks global private equity and venture capital investment, found that about 43 percent of responding firms indicated they would close between one and three deals in 2017. Twenty-nine percent said they would close between four and six deals.

One of the Calabasas Capital transactions was for Modul Marble & Granite, a stone and tile importer and distributor in Sun Valley. The company was acquired by Architectural Granite & Marble LLC, owned by private equity firm Trive Capital in Dallas.

The deal was indicative, Bonrouhi said, because it shows an interest in the building products industry by investors. Also, it illustrates a pattern of larger companies owned by private equity looking for lower middle market companies to buy and consolidate, he said.

“We are very often able to take advantage of that trend for our clients, and selling to private equity-owned companies that are much larger,” he added.

Blaine, of Mentor Group, had two deals he was working on that he expects to close in the first quarter of the year — an aerospace company in Santa Clarita and a software firm in the San Fernando Valley serving the telecom industry.

“It is going to be big for the industry and show where the tide is going,” Blaine said of when that transaction closes.

#### Exit strategies

While overall in North America and Europe the number of merger and acquisition deals fell by 25 percent to 13,121 in the first three quarters of 2016, the value of the deals came in at \$1.7 trillion, a 10 percent increase over the same period a year earlier, according to data from PitchBook.

Typically investment banks work with established companies with a proven track record. The owners or management of these companies may be having trouble growing the companies and are looking for a buyer or a partner.

“Usually it’s more the former than the latter,” said Crowley, the attorney.

Reasons why owners or management sell has little to do with market demand, added Bennett, of Lionfish Advisors.

They are selling because they are ready to retire or have taken the company as far as their skills and experience allow, he said.

“For the company to continue growing, it’s going to need a more sophisticated operator or more resources than they have,” Bennett explained.

In terms of deal structure, investors first want to make sure they get their money back. They can accomplish this by lending money to the company they buy and then taking money out of the profits as interest on the loan. This also serves to pay lower taxes on the gains.

If a company does not perform well, investors can claim it is worth less than what they put into it and then foreclose, Crowley said.

“Owners can get sometimes a rude surprise with that,” he added.



“TODAY, THE LOWER MIDDLE MARKET IS THE STRONGEST SEGMENT OF THE OVERALL MIDDLE MARKET IN TERMS OF PRIVATE EQUITY. — David Bonrouhi

Sometimes, a private equity fund wants to buy a company because they have the perfect person in mind to run it.

Blaine said he was in that situation last year when a letter of intent was signed for a Valley company that the buyer later backed out of when the person they had in mind to be chief executive had other plans.

The buyer was more interested in putting that specific chief executive in place than they were in really owning the business, he said.

“A lot of it is just plugging in chess pieces,” Blaine said.

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