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Good Things In Small Packages?

The big PE shops profess their love for the middle market, but some deal pros question whether they have the right stuff

BY Ken MacFadyen

The middle market was greeted with a new entrant in August, as the **Blackstone Group**, still armed with $14 billion of dry powder, declared in its second-quarter earnings call that the middle market was its "sweet spot."

This is probably news to most pros working on deals below the $1 billion threshold. Few, though, should be surprised to see compression in a market that was stretched beyond all recognition in the four preceding years.

Of course, Blackstone is not alone in setting its sights on smaller deals. **TPG Capital**, for instance, has notched a few investments that might be considered "mid-market," and **Kohlberg Kravis Roberts**' 2008 acquisition of **Unisteel** was the firm's first in a while that dipped below $600 million in enterprise value.

Blackstone and KKR did not return calls for this story.

The evaporation of megadeals occurred so abruptly that funds modeled for acquisitions ranging from $5 billion to $15 billion in size were left without a market. The obvious solution is to go downstream. Pros in the middle market, however, warn that such a move, though logical, is not easy.

"It's a foreign language for most of these guys," says **Lloyd Greif**, the CEO of **Greif & Co.**, noting that one of the biggest hurdles for large-market firms will be culture shock. "The emphasis is on the word 'partner' in the middle market," Greif says. "To build a rapport takes time and a lot of hand holding; that's the one thing large buyout shops can't afford to invest."

Harvard's **Josh Lerner**, the Jacob H. Schiff professor of investment banking at the business school, notes, "The implication of doing smaller transactions means the sponsors will be looking at a lot more opportunities. The question becomes, how do they manage that process?"

Lerner says firms' investment committees—made up of a relatively small group of senior executives—"work really well with multibillion-dollar transactions" but may not have the bandwidth to keep up with deal flow that no longer has a sieve.

KKR's most recent $17.6 billion fund, raised in 2008, for instance, would yield almost 60 portfolio companies, assuming an average enterprise value of $750 million, with an equity contribution accounting for 40% of the capital structure. Of course, that is a simplified model, but it underscores the challenge facing the megafirms.

Oliver D. Cromwell, president of the middle-market advisory firm **Bentley Associates**, says that, beyond accumulating the portfolio, managing the assets would further stretch capacity. Cromwell noted that the task of improving a middle-market business differs widely from large-market turnarounds.

"It's hard to quantify, but in the middle market, businesses and management teams need active assistance when it comes to getting professional systems in place," Cromwell says. "Everything from financial reporting to controls to marketing, it all needs active oversight. The larger firms are used to companies that already have sophisticated systems in place."

This is not to say that large-market firms won't have some advantages. For instance, Lerner points out that many of the larger firms have developed vast networks as they've grown. "Presumably, those relationships, whether it's CEOs or political leaders, can be just as valuable to a mid-market company."

Moreover, though critics point to the potential scale of the portfolios, Blackstone aims to use this to its advantage. It established what it calls CoreTrust as its group procurement platform. Currently, 80% of its portfolio companies participate, consolidating most of the purchasing by its holdings—be it for paper, air freight or computers. Blackstone has a similar platform to consolidate portfolio health-care coverage. The increased buying power, the firm says, is expected to yield $260 million in savings this year for its portfolio.

It's also important to distinguish the "middle market" the megafirms will be targeting from the middle market most other sponsors are familiar with. **Thomas Shields**, a managing director of the Waltham, Mass., advisory firm **Shields & Co.**, says the definition of mid-market is open to interpretation. "In and around Boston, you're generally talking about transaction values ranging from $100 million to $500 million in size," he says. "I think for the larger firms, they would probably consider that to be the small market."

Indeed, on Blackstone's conference call, CEO **Stephen Schwarzman** cited the firm's investment in **Apria** as "one of our most recent mid-market acquisitions." At an enterprise value of $1.6 billion, few traditional mid-market sponsors would consider that within reach. For a firm that sealed a $39-billion deal only a few years ago, it is easy to see how the definition of middle market can be relative.

Despite the differences, most middle-market pros aren't completely dismissing the ability of the Blackstones and KKRs of this world to move down market. But nobody is willing to say it will be easy either.

"Ultimately, there are two things that will make the difference," Greif says. "One is if they can hearken back to the entrepreneurial roots of the shop and the same people are still around to oversee the efforts. The second factor is whether the mentality to pursue middle-market deals is still in place because this arena takes more effort and more skill."