

# Increasing Private Equity Deal Flow With An Indirect Channel Strategy



By Kevin Fiala and Jonathan Rubin

In their search for deals with attractive returns, private equity firms in the 21st Century face challenges that their 20th Century forbearers never considered. First, the sheer number of private equity firms competing for deals has increased dramatically. According to Thomson Financial, in 2004 there were more than 5,000 private equity firms in the U.S. alone. Add to that another 4,000 private equity firms throughout the rest of the world.

Second, there is a far greater volume of money chasing those deals. McKinsey & Co. has estimated that the private equity capital overhang in the U.S. is \$90 billion and in Europe is \$39 billion. Third, investors from other asset classes, including strategic buyers and, notably, hedge funds, have witnessed the success of the private equity world and now scour the landscape for similar deals.

Private equity firms have responded by stepping up their own efforts to increase deal flow. They have invested in comprehensive web sites and glossy brochures. Some hire junior staff to “dial for dollars,” cold-calling hundreds of companies every day to find companies not on anyone else’s radar.

## Valuable Deal Sources

Another time-honored source for deal flow is the intermediary channel.



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In addition to sources of casual referrals, such as attorneys and accountants, the intermediary channel also includes “professional intermediaries,” those firms and individuals who make a full-time practice of putting buyers and sellers together. Historically, private equity

firms have made good use of this important channel as a source for deal flow.

Yet private equity firms face a challenge in working with intermediaries. The phenomenon of increased competition for deal flow has an echo in the intermediary channel. Private equity firms, as well as strategic buyers and hedge funds, also compete for the attention of the intermediary channel. This competition makes it difficult to differentiate your private equity firm from all the other potential buyers to which an intermediary could bring a deal. Yet while private equity firms are insistent on compelling many of their portfolio firms to develop sales strategies that utilize both direct and indirect sales channels, many private equity firms have not developed strategies for getting the most out of the indirect intermediary channel for sourcing deals.

The ever-vigilant, sharp, and tenacious private equity partner understands that intermediaries are potential sources of deals. Therefore, the partner reaches out to an intermediary, puts him on the firm’s mailing list, chats with him when the partner sees him at conferences, and may even give him a call every now and then. Too often, however, that

communication is not systematic and thus fails to distinguish the partner's firm.

For example, we at Westbury and Bywater seem to receive dozens of e-mails — from firms we know and firms that contact us blindly — that could all have originated at the same firm. An example, "We are seeking to acquire companies with at least \$5 million in EBITDA, a record of steady earnings, and top-line revenue growth. The quality of the management team is very important to us. We are open to a wide range of industries." So when a deal with such broad criteria comes to one of our firms, who do we call first out of the dozens private equity firms available?

## Working With Intermediaries

As intermediaries, Westbury Group and Bywater Corporate Development Services have an insider's view of the challenges facing a private equity firm wanting to use the intermediary channel. We have worked with many private equity firms and have seen effective and ineffective ways that such firms work with intermediaries.

Based on our experience, we developed a set of recommendations for private equity firms to create a strong channel with professional intermediaries. To help our clients understand how to make the best use of our services, we researched the issue by conducting a series of extensive discussions with a wide range of intermediaries, from one-man shops to established multi-partners firms. In each of these discussions we proposed the following hypothetical scenario to each intermediary.

Suppose that through networking, research, prospecting, or some other means, you come across a manufacturing company with the following profile:

- Privately held
- Sales of \$25 million
- EBITDA of \$4 million
- Good growth prospects
- Wants to sell
- Will not sell to an industry competitor
- Would stay on to run the business for a transition period

Furthermore, because the company is loath to sell to a competitor, it is interested in exploring a sale to a private equity group. How would you

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handle this situation? Would you seek a sell-side engagement with a company or a buy-side engagement with a private equity firm? Would you work with multiple private equity firms simultaneously or just one? And to which private equity firms would you present the opportunity?

## Intermediaries' Perspective

Before providing the intermediaries' answers to our hypothetical situation, we think it important to share our understanding of the economics of an intermediary. Gaining this understanding is analogous to an operating company learning about its channel partners' economics before setting up a channel partner program. The intermediary's business has two key economic characteristics: First, it tends to have low- to moderate-overhead. At the low end of the range, some intermediaries operate out of lower-rent or home offices, with modest equipment, little to no administrative staff, and limited fixed costs. More established firms might have upscale space, subscriptions to relatively expensive industry databases, more extensive office staff, and greater fixed overhead.

Second, the intermediary business is a numbers game — the vast majority

of deal discussions that the intermediary initiates will not end in a deal. Based on our experience, we estimate that only one out of every 50 serious discussions will culminate in a signed agreement in which the intermediary earns a success fee. Thus, especially for smaller firms, the difference between a great year and a horrible one may only be one or two deals.

## Intermediary Value Chain

Next, private equity firms should understand the intermediary's value chain. (see Figure 1). The important lesson to take away from this is that most of the intermediary's costs are incurred in the first three steps. Understanding the value chain makes it clear why the intermediaries indicated that, in the hypothetical situation we posed, their first choice would be to engage the seller in a sell-side agreement. The probability that any one buyer will close on a deal is fairly slim, but absent some fatal flaw or cold feet on the seller's end, intermediaries know that, given the high demand for good deals, they can probably find someone to buy the company. Sell-side agreement provides intermediaries with more control of the deal and a higher probability that the intermediary will earn a success fee at the conclusion of the deal. >>

*To be continued in the November issue.*

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Figure 1: Simplified Intermediary Value Chain					
Value Chain Steps:	Identify Buyer or Seller	Contract with Client	Identify Counterparty	Facilitate Transaction	Close
Stage/Probability of Closing a Deal:	Concept: 2%	Contract with Client: 5%	Serious discussions: 20%	LOI: 50%	Final documents: 90%