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First Thoughts on Deal Sourcing

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Key Topics in Chapter 1:

- Why deal sourcing remains an obscure field
- Six action steps to take today to enhance your deal origination prowess
- Proven deal sourcing strategies and the search for the mythical proprietary deal
- How to assess your current deal sourcing capabilities
- Key trends to look for now to spot future private equity deals ahead of others

Introduction to Deal Sourcing

Private equity begins with finding a suitable investment opportunity. Preferably, a great one. The first three chapters of this book discuss exactly that—the process of finding a private equity deal that represents a perfect fit for your investment mandate.

In my personal experience, I have found this to be a tedious and frustrating process. Why? The private equity industry has been operating for nearly half a century, yet there is no one source that educates others in a granular and systematic way about how to build a solid private equity origination capability. Therefore, I set out to put my own detailed thoughts and experience in writing in order to share my perspective with others about this complicated process. My aim is to be as thorough as possible so that, after reading these first three chapters, you will walk away with a couple of solid and useful frameworks that will positively transform your deal sourcing outcomes.

Let's begin.

Why is understanding deal sourcing important? There are two primary reasons. First, creating and sustaining a flow of high-quality deal ideas is one of the core competencies of a successful private equity professional. This competency resonates very closely with the perceived brand of every private equity fund and, eventually, with your personal brand. Every limited partner ("LP") investing in private equity funds is looking to identify a team of rainmakers who can demonstrate that they are capable of developing differentiated investment themes, finding sustainable sources of deal flow and closing successful transactions. As you get more experienced in private equity, the people you report to will increasingly expect you to originate your own deals proactively.

The second reason is that deal sourcing—while being critical to investment success—remains remarkably obscure. There is extremely little written specifically about private equity deal sourcing and how to master it. The books on private equity that I have researched seem to include only a high-level discussion of this topic. If you are interested in private equity, chances are you regularly come across articles in the trade press discussing the challenges of finding a good deal. If you have attended private

equity conferences, as I have, then you've also heard a good number of deal origination war stories. However, I wasn't able to find a single resource that sets out a detailed private equity deal origination framework in one place. Hence, I believe I can make a contribution to this area with my deal sourcing guide.

In my research, I was able to identify only one study, conducted by Teten and Farmer (2010), analyzing deal sourcing strategies across the private equity industry and outlining a number of actionable steps aimed at improving the deal origination process. Unfortunately, I could not use the valuable lessons of this study in my own career because this research was published many years after I had been tasked with originating my own private equity transactions. In the study, the authors reaffirm the importance of deal sourcing in private equity: it turns out that late-stage venture capital and growth equity investors with proactive origination programs are almost all top-quartile performers across stage, vintage and sector. This makes sense. You can now understand why LPs might be very interested in examining your firm's deal sourcing process in agonizing detail.

When I started my first private equity job at a firm focused on large leveraged buyouts ("LBOs"), I found the process of deal origination and initial review fairly exciting. It was great to think through numerous business models and admire new ideas. However, it was also extremely exasperating. I was a member of the consumer team and it was not unusual for us to analyze over 100 large buyouts a year, bring 10–12 deals to the investment committee and work on three or four full deal execution processes in order to close just one transaction that year.

Yes, you read that correctly: the goal of my team was to review over 100 potential deals in order to close *one* deal per year. If you are lucky enough to complete one transaction a year, you are right on track! Sometimes, even this modest goal was out of reach. For example, when a target company was sold through

a highly competitive auction process, our team would often not be chosen as the preferred (or highest) bidder. This means that there were years when we, as a sector team, would close no deals at all. Yes, we would still review over 100 potential deals that year and close zero. Talk about a low-energy Christmas party.

This is a rather frustrating, yet typical, fact in private equity: a lot of work goes into deal sourcing yet there is no guarantee of a successful outcome. Sometimes several years will pass from your first meeting with the management of a potential investment target to the time they are ready to consider a transaction. Sometimes the company will even go through multiple rounds of ownership until the management team is prepared to meet with you again. Sometimes the company shareholders are finally ready to accept a private equity investment, just not one from your firm! However, the stars do align at some point and, with perseverance, you can manage to get a private equity transaction to a final close.

What influences the successful outcome of sourcing and closing a private equity transaction? If you had asked me this at the beginning of my private equity career, I would have said that there was a fair degree of randomness and luck in this process. It is about being connected and about maximizing your options by doing 1,000 things to cover more ground. And being in the right place at the right time. And balancing cold-blooded investment analysis with the animal spirits of a competitive auction. Back then, I would have said serendipity deserves its fair share of credit, too.

Would I give the same answer now? Actually, I would not. I no longer think of sourcing and closing transactions as a game of chance. While the rules of probability do apply to finding good deals, I think there are steps that you can take to skew the odds in your favor. Sometimes significantly. Depending on what your competitors are doing in your sector or country of focus,

you can definitely enhance your deal origination prowess by a considerable margin. I have certainly seen this in my own efforts of sourcing private equity transactions.

First, let's take a look at a broad overview of these action points and then I'll delve into each one in more detail.

- *Commit*. Make deal origination an institutional priority and aim to create a sustainable long-term competitive advantage both for yourself as an investment professional and your firm through sourcing high-quality investments. This means dedicating time to deal sourcing throughout the year even when it seems like there is no time for it.
- *Organize chaos*. Deal sourcing is tricky because it is an informal process that involves many variables. Decision-makers change their minds. Companies get taken over by strategic investors and cease to be private equity targets overnight. What can you do when things seem out of your control? Attack the mercurial nature of deal sourcing by turning your reactive activities into a number of intentional and predictable routines. Systematize your efforts and turn them into a framework. Focus on perfecting your deal sourcing process and do not pay excessive attention to interim outcomes. A better process will eventually lead to superior results.
- *Conduct deep industry research*. Create a unique information advantage for yourself and your team by developing expertise in a couple of industry subsectors. Make sure you build a detailed knowledge base in these subsectors, generate your own insights and initiate a flow of proprietary deal ideas. How do you do that? I have spent many late nights leading various industry "deep dives" and have developed my own framework for tackling this exercise. I will share these tactics with you later in the book.

- *Prepare your firm to move quickly*. Institutional agility can be a remarkable advantage, especially in a highly competitive deal environment. It is important to provide regular updates to your firm, especially your investment committee and key decision makers, on the main investment themes that you are working on. The goal is to get as much support as possible and ensure that everyone is aware of the detailed knowledge your team has acquired through deep research. One of the best ways to do this is for your team to develop and share their proprietary analysis of a sector with the rest of the firm. That way, once you identify a suitable deal in this industry, your investment committee should already be warmed up. They will trust your team to come up with a differentiated "deal angle," giving you the ability to move forward with confidence and progress the deal ahead of your competition.
- *Develop an efficient deal sourcing process*. Take a step back and identify the areas of your deal sourcing process where most of your time is wasted. Does it feel like you are busy creating too many options by doing 1,000 things? Are you attending too many meetings with intermediaries who miss the point of your mandate and bring deals that make no sense? Is your deal sourcing network fully optimized? Are your meeting notes well-organized, searchable, synchronized and easy to access, both in the office and remotely?

Once you have had an opportunity to reflect, try to come up with ways to streamline your deal sourcing process. Aim for the end result to resemble a clock with a precise Swiss movement. Instead of doing 1,000 things to cover more ground, reduce your efforts to the 10 most value-added activities and repeat them with precision 100 times. These numbers are arbitrary, but you get the point: abandon deal sourcing tasks that yield no result, focus on the most productive activities and pursue them

in a disciplined manner. This process should free up some of your time and enhance the quality of deals under your review, both of which will boost the probability of a successful outcome.

- *Persist, smile, repeat*. Now that you have created a proactive deal sourcing work plan, make sure there are dedicated slots reserved in your calendar to keep the process moving. Deal sourcing should be relentless and tick away with the dependability of a clock. Do not be tempted to drop out of the deal origination process, even during busy times. You can simply do less deal sourcing work during busy weeks. The only way to beat your competition is to work smarter. Take the time to put necessary reminders in your system for any follow-ups and be disciplined about following through completely. Do your best to maintain a positive spirit when deals disappoint. Take a deep breath, smile, move on and start again. Deal sourcing is simply a fixed number of efforts, persistent and repetitive, that eventually result in a big payoff.

Originating new deal ideas can sometimes feel like a mammoth task, but taking small steps can make it much more manageable. Just a few hours a week of proactive and intentional deal sourcing work can make a big difference and help you stay ahead of your competition. As the old proverb goes, "Water dripping day by day wears the hardest rock away."

Deal Sourcing Strategies

What sourcing strategies are out there? Generally, people in our industry talk about two types of private equity deals: thematic and opportunistic. Thematic investments are potential transactions that you identify proactively through the rigorous and granular research of a particular industry subsector, emerging trend or a specific investment thesis. Thematic deal ideas sometimes do not

have any obvious catalysts and can take a long time to become actionable. Opportunistic investments rely on a more passive effort on your part: they are inbound transactions that simply land on your desk. Opportunistic transactions are typically a lot more actionable: there is often a motivated seller who wants to get a deal done within a specific timeframe. The majority of opportunistic deals are introduced by sell-side intermediaries, professional connections and, less frequently, friends or acquaintances.

Based on what I have seen in the private equity market, most firms tend to pursue both types of deal sourcing approaches in order to develop a sustainable flow of new investment ideas. Thematic deal sourcing helps you narrow down your area of focus and build a knowledge base, which in turn increases the probability of finding an opportunistic deal in which your firm can position itself ahead of the competition as the most credible buyer.

The longer I worked on both thematic and opportunistic transactions, the more I thought about how to optimize the deal search process for both types of deals in order to create an effective routine. It took me many years, with many ups and downs, to outline a set of steps for myself that were easy to follow and gave me confidence that I was being thorough in my work and spending my time efficiently. The effort of documenting my deal sourcing approach ultimately morphed into a couple of fairly detailed frameworks which I will describe later in the book. What was I trying to achieve? I thought that the holy grail of my deal sourcing activity was to find a proprietary deal, either opportunistic or thematic.

Finding a proprietary transaction is a true obsession of the private equity industry. What makes a deal truly proprietary? When the transaction is not widely known in the market and your firm is the only party having discussions with the target company, then you are working on a proprietary deal. Sometimes the deal can be semi-proprietary: a few other market

players might be aware of it and circle the same target. However, it is possible that your firm may be ahead in its learning curve and, therefore, manage to agree a period of exclusivity, during which you can evaluate and execute this investment. There may be cases when your firm succeeds in engaging in a truly proprietary dialogue with a great business found through months-long thematic research, only to be told by company owners that they will invite additional bidders. Why? Mostly because multiple bids typically make price discovery more accurate and give the owners an opportunity to maximize valuation. In this case, your proprietary idea will enter the open market and, I can tell you from my own experience, it is a rather painful feeling.

Why is it so hard to find proprietary deals? The private equity industry has matured over the years and there are literally hundreds of new funds entering the industry across the globe each year. As information barriers diminish, company owners are getting more sophisticated too, and are far more likely to hire a professional adviser than deal with just one private equity fund in a proprietary transaction. So, why do private equity investors continue to obsess over finding a proprietary deal? Well, everyone likes a competitive sport. Also, finding a proprietary deal is a great opportunity to showcase your professional finesse and highlight your fund's distinct advantage to your LPs. Your fund investors will feel like they have gained access to an exclusive deal club and, provided your fund's returns do not disappoint, will be keen to invest in your next fund when the time comes.

Theoretically speaking, finding a deal outside of a competitive auction should result in a lower entry valuation too. As the only bidder, your fund may avoid having to overpay in order to secure the deal. However, I am not so sure that the notion of a more reasonable entry valuation holds every time. I can think of a number of scenarios in which your fund may decide to pay a fairly high valuation in a proprietary situation. For example, your sector

expertise may enable you to take an informed view of unique value creation levers that exist only in this company and not in other comparable businesses. You might decide to pay a premium because your fund may value transaction certainty and seek to benefit from lower execution costs. These are just some of the reasons that might explain a higher entry valuation in a proprietary transaction. Teten and Farmer (2010) remark in their study that sometimes private equity firms agree to pay a higher multiple of earnings for a proprietary deal because it enables them to pursue higher quality targets to begin with and also add more value after the deal closes.

In summary, proprietary deals have become exceedingly difficult to find—but they are not just a myth of the private equity industry. It makes more sense to think of them as an infrequent but completely plausible phenomenon, like a solar eclipse. As rare as they are, we can still expect to experience them once, and hopefully even multiple times during our careers.

Assessment of Your Current Deal Sourcing Capabilities

Let's take an honest look at where you are at the moment. Do you think your firm has strong deal sourcing capabilities? To distinguish good luck from a solid origination process, it might be helpful to think through and answer the following questions.

- Does your fund set tightly defined investment goals for the next 12–18 months? Does your firm have a well-articulated sourcing strategy?
- Does your firm pursue a research-driven thematic deal sourcing approach? Are there specific investment theses that you are developing in your area of focus?
- How many proprietary deals has your firm sourced and what origination strategies were most successful?

- Does your firm capture detailed data on the deal pipeline? Are you able to analyze past and current deal flow with basic pipeline key performance indicators ("KPIs")?
- Do you know what proportion of deals your firm has seen that are relevant to your area of focus? How many deals has your firm missed? Of those deals that were missed, how were they sourced? Do you have access to the same deal source?
- If your fund saw the deal and rejected it, is there anything in the investment thesis that you failed to detect that other firms were able to spot?
- Do you maintain a list of potential deal targets? Do you use a tech-enabled solution that allows you to keep track of them easily? Do you reach out to them consistently and follow up? Do you keep in touch with companies that currently appear to have no interest in selling?
- Do you record key takeaways from meetings and calls that various members of your team have had with a potential deal target over the years? Is this information stored centrally and easy to access?
- Does your firm have a good system of keeping track and systematizing firmwide relationships, such as with banks, consultants, industry experts and other professional intermediaries? Are you able to rank your relationships based on the value they provide to your firm?

These questions, no doubt, represent a degree of self-reflection and discipline that can seem hard to reach. If your firm does not follow most of these processes, do not worry. These procedures are fairly straightforward to establish and, once in place, they will produce substantial benefits. If your firm already operates in a fairly organized way, then you are already ahead of the game and any incremental deal sourcing efforts should result in an even greater tangible payoff.

Where Do Deals Come From?

Have you ever wondered how a deal actually originates? What factors propel private equity activity? And why do deals come in waves? The reason why I care about these questions is the following: if you understand what emerging trends are likely to spur private equity deal activity in the near future, you can focus your deal sourcing efforts on this arena and position yourself ahead of your competition. In other words, if you are more observant than others, you can try to figure out where deal activity might happen much earlier than anyone else.

One of the intriguing aspects of private equity deals is that they take place in both good and bad market conditions. Theoretically, most private equity deals should happen in a bear market. When the IPO window is closed, the public markets are pessimistic and banks are less willing to provide debt on attractive terms; thus the shareholders of target companies should view private equity as a more appealing financing option. This theoretical argument can be extended further: private equity funds themselves should be able to take contrarian views in a bear market and seek to invest heavily in a down cycle. This will allow them to pay relatively low entry valuations and generate attractive investment returns. Does this happen in reality? Not as often as it should.

My observation is that private equity activity as a whole ends up being quite pro-cyclical. Of course, there are disciplined private equity investors out there who abide by their strict valuation criteria and who avoid investing at the top of the cycle. However, most market participants are human and, therefore, are likely to succumb to hubris when they observe rapid economic expansion and rising stock markets. Valuations are high when the markets are optimistic; however, one can always justify paying a full price for a good business. A deal frenzy begins and

eventually swallows the majority of market participants. This explains why deals come in waves.

Since little research exists that links emerging trends to the private equity activity, I found it useful to look at the field adjacent to our industry, namely that of mergers and acquisitions ("M&A"). There is an outstanding book by Bruner (2004) that, in addition to discussing nearly all key areas of applied mergers in impressive detail, addresses precisely this topic. Bruner (2004) looks at what drives the M&A deal activity and identifies areas of "economic turbulence." Some of these factors provide a good explanation of the private equity deal activity and are useful to keep in mind in your deal sourcing efforts. They are as follows:

- *Geopolitical change*. Political decisions can radically change the attractiveness of certain markets. Any shifts in policy that affect the prosperity of the economy, taxation, social environment and corporate governance will have profound implications for private equity transactions. For example, I owe thanks (and deals) to the following geopolitical developments that influenced my private equity career: the introduction of the single currency in the Eurozone, the inclusion of certain Central and Eastern European states to the European Union, the admission of China to the World Trade Organization as well as market deregulation reforms that followed the economic liberalization in India.
- *Secular trends*. Examples of secular trends include long-term shifts in the demographic makeup, the need of labor migrants to sustain economic expansion, vast differences in wealth distribution across generations, rising obesity rates and distinctive preferences of younger consumers, just to name a few. Any sustainable long-term macro shift could provide a fertile ground for investment.

- *Changes in regulation*. Deregulation is typically very beneficial for businesses, as their growth becomes less constrained and they can play by the rules of the market economy. Companies typically need to rationalize their operations in order to compete. On the other hand, when regulation tightens, businesses often have a need for fresh capital in order to comply with the changes that might be as extensive as having to adapt their entire business model. There are second-order effects too, such as the rise of new entrants providing tools and services that aid compliance in the new regulatory setting.
- *Technological change*. Do you remember how the world worked 10 years ago? Technological advances can be very disruptive for companies. Apart from requiring additional investments in infrastructure and personnel, technological shifts might compel companies to alter their strategic direction and invest in new capabilities in order to survive.
- *Innovation in financial markets*. Increasing market sophistication has a direct impact on the private equity industry. Examples of complex transactions that added fresh momentum to the sector include the advent of the LBO and securitization of leveraged loans. The introduction of certain structural features in private equity transactions such as a "sale and leaseback" has been replicated across numerous private equity–backed businesses that own hard assets.
- *Changes in capital market conditions*. Buoyant markets enhance deal activity. During record market highs, even businesses with no earnings, no revenues and, sometimes, no customers get bought and sold. When the markets are very liquid and are forgiving of corporate shortcomings, hubris takes over the world. As I mentioned earlier, private equity activity, at least theoretically, should abate. It does eventually but, as a rule, a little too late.

There are a couple of other deal factors not mentioned by Bruner (2004) that are important to include in this discussion:

- *Industry disruption*. Private equity firms are generally enthusiastic about backing industry disruptors. Traditional classroom education providers, retail banks and insurance companies are examples of industries being disintermediated by new entrants backed by private equity investors. However, it would be fair to mention that private equity funds sometimes fail to spot a terminal inflection point in the industry and let disruptors attack companies in their own portfolio. For example, some of the biggest losses in private equity occurred when the business models of music publishing and brick-and-mortar retail companies were completely dismantled by the online competition.
- *Sectors with substantial capital requirements*. Sometimes there are entire industries that announce large capital expenditures that will need to be incurred by companies operating in that sector. Examples of such capital investments include purchases of new spectrum in telecommunication auctions, the move to hybrid or electric engines in the automotive sector, the development of new techniques to extract fossil fuels and financing the gradual switch to alternative energy sources in power generation.
- *Applying successful business strategies to new industries*. Private equity excels at identifying proven business models that can be applied to new sectors. On-demand services, asset-light operations, outsourcing, "buy and build" strategies are just a few examples of what has been replicated across industries. Private equity investors look for appropriate business analogies and think: If restaurants operate as a chain, why don't nurseries or schools operate as a chain?

- *Replication of successful deal types in new geographical markets*. When private equity arrives in a new geography, especially in emerging markets, first deals tend to happen in telecommunications, breweries and branded consumer goods. Why? Because straightforward deals happen first. Private equity funds always seem to be keen to pursue proven investment theses in new countries where there are enough imperfections to warrant a high return.

Is this an exhaustive list? By all means, it is not. You can probably come up with additional factors driving private equity deal flow that are relevant to your industry or geography. It is always worthwhile to keep a close eye on any emerging trends in order to anticipate potential transactions and stay ahead of your competition. As soon as you identify the areas of so-called "economic turbulence" that seem relevant to your investment mandate, rush to your desk to research them so that you can spot future deal flow before anyone else.