PE Hub

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PE DEALS

Lateral's De Silva predicts return to a more 'normal' investing market

'We look forward to a market where rational investors are appropriately rewarded for taking risk and building value,' he said.

PE Hub's ongoing Q&A series with private equity leaders reflecting on highlights from 2022 and sharing their outlooks for 2023 continues now with Richard De Silva, founder and managing partner of Lateral Investment Management. Based in San Mateo, Lateral is a mid-market PE firm investing in lower-mid-market companies in the manufacturing, healthcare, infrastructure and technology sectors. In May, Lateral invested in FirstClose, an Austin-based provider of data and workflow software for mortgage and home equity lenders.

Richard De Silva, Lateral Investment Management

Q What were the highlights of your dealmaking in 2022?

The dealmaking environment changed significantly in 2022 after years of frenzied activity and an inflating bubble. Lateral is a value-oriented investor, and our bar for doing new deals was raised further as we looked for opportunities in the context of a rising rate environment and a recession. As a firm, we generally focus on business-to-business companies with long-term contracts and avoid transactional, consumer-focused companies. In 2022, with an eye on a likely recession around the corner, we have been looking for companies with strong secular tailwinds that are less vulnerable to the business cycle and, wherever possible, that have counter-cyclical trends.

Q What was the biggest challenge to completing deals in 2022?

The public market volatility and decline in valuation multiples resulted in wide spreads between updated purchase prices for buyers and lagging expectations of value from sellers. Company valuations based on double-digit forward revenue multiples no longer made sense. Going from these nose-bleed valuations to mundane single-digit trailing EBITDA valuations gave a lot of sellers whiplash – or at least has resulted in an extended period of denial. The result has been a lot of failed auctions, broken deals and disappointed investment bankers. We remained disciplined in 2022 and were surprised at how many times we were outbid on transactions by significant multiples. Many of those transactions were never consummated and we are revisiting some of the most interesting opportunities at better prices. I think we will see more compelling opportunities at rational valuations in 2023.

Q How do you expect the first six months of PE dealmaking in 2023 to compare with the last six months of 2022?

We expect the first half of 2023 to be a good time to focus on hardy, disciplined companies that focused on profitability and have healthy contractual backlog for growth. There will be audited financials and budgets that are based on reality rather than hope. During the last six months of 2022, it was difficult to assess re-forecasts and changing capex budgets, sales pipelines that were stalled and short-term accounting games. We also expect the Fed to stop tightening by mid-year, which will stabilize the macro outlook and provide visibility on growth.

Q What will be the most important trends affecting your dealmaking in 2023?

Here are four trends that may impact our dealmaking and our portfolio companies over the next 12 months.

1. Serving cost-reduction mandates: As corporate America switches from growth at any cost to an increased

focus on profitability, the mandate is to reduce internal cost centers.

2. Positive labor trends: Hiring and retention are becoming easier and skilled workers are more concerned about job security.
3. Accretive strategic acquisitions to build scale and geographic reach: Conditions are improved to roll up sub-scale competitors at attractive valuations. With a strong dollar, US companies have the opportunity to acquire high-quality international targets at discounted values.
4. Improved competitive dynamics: The economic weakness and the pull-back in exuberant capital markets will no longer prop up weak value-destructive competitors and put an end to the short-term irrational business practices that have hampered healthy markets and eroded margins without creating sustainable value.

Q **What's keeping you up at night?**
We expect a mild and relatively short recession but are worried about significant negative undercurrents in the United States or externalities outside of the country that change that outlook to a more severe or extended recession.

Q **What are you looking forward to most in 2023?**
We are looking for a return to a more "normal" investing market in the back half of 2023 during which inflation is tamed, rates are stabilized and company performance is dependent on strong fundamentals and disciplined execution, rather than market momentum or a financial bubble. We look forward to a market where rational investors are appropriately rewarded for taking risk and building value, rather than the warped rate environment, irrational exuberance and correlated performance which has characterized the past decade. ■