EUROMONEY

The mid-cap champion: How Houlihan Lokey plans to keep on growing

A stellar period for the independent investment bank, including its largest-ever acquisition, has set the scene for a strong future, according to CEO Scott Beiser. Its relentless focus on the mid-cap arena and its naturally hedged balance of businesses have created a firm that has quietly become one of the biggest advisory names in the world

Mark Baker

Scott Beiser sounds understandably upbeat. As the chief executive of Houlihan Lokey prepares to report the investment bank's third-quarter earnings for the last three months of 2021 on February 8 (its financial year runs from April to April), he can reflect on record year-to-date results and the completion of the biggest acquisition the firm has ever undertaken, its purchase of Tokyo-listed tech-focused investment bank GCA in October.

Houlihan's revenues rose 32% in the 2021 calendar year to more than $1.5 billion, with its corporate finance division up 24% – making up just over half the firm's total. Its restructuring unit accounts for 35% of revenues, with financial and valuation advisory making up the rest. Pre-tax profits for the group rose 73% over the same period.

And the stock has been on a tear – it is up 115% since the start of 2020, after being down only about 7% at its Covid low on March 25, 2020. That's the kind of performance that most of its rivals can only dream of.

The firm was bolstered against market downside by its status as a hedged play on likely distressed markets, thanks to its restructuring credentials. But in the end its performance has been driven by a more benign environment than had been expected and by its ability to take advantage of the broader corporate finance opportunities afforded by conditions that have favoured deal flow, particularly from financial sponsors.

"I've been in the business for decades and this is about as robust a marketplace as we have seen," says Beiser, a 38-year veteran of the firm and chief executive since 2003. "Twenty-four months ago, you would never have predicted where we are at now."

The overwhelming majority of companies are doing well, he says. There is still a large subset that are not, mostly businesses that had the wrong business plan heading into the pandemic. And he acknowledges that government support of financial markets has been substantial.

But what strikes Beiser is the broad nature of positive drivers for his firm's business.

"I don't think it is centred in any one industry or geography," he says. "What typically happens in our business is that you wish that one geography or one industry had done better. You ask what are your lagging components. But there aren't that many right now."

One reason for Houlihan's success in this its 50th year is the nature of the pond it plays in, which is the mid-cap space, defined by the firm as an enterprise value of up to $1 billion. It is there partly by choice and partly because that is where the competitive landscape has traditionally allowed the firm to shine. For Beiser, the relative weighting of those two doesn't much matter: he is comfortable with the firm sitting exactly where it is.

"We are happy to be in the space we are in – it fits with our diversified approach," he says.

The way Beiser sets out the firm's thinking, it's straightforward enough. Analysis of the global advisory business typically places much focus on the total dollar value of transactions. But he prefers to look at the number of deals, which he says is a much less volatile measure.

That's because the aggregate dollar value of deals in a given year can fluctuate hugely based on the presence of mega-deals. About 70% of the $5.2 trillion total value of M&A deals recorded by Dealogic in 2021 was accounted for by deals of $1 billion and above. But those represented less than 3% of the total of nearly 35,000 M&A deals.

And the volatility of those biggest deals is extreme. According to Dealogic, the number of $1 billion-plus deals dropped nearly 60% between 2007 and 2009. Their smaller cousins fell just 12%. Taking the period from 2007 to 2021, the peak-to-trough range for the number of the biggest deals versus their average for that period is fully 81 percentage points. For sub-$1 billion deals, it is just 30 points.

Houlihan's mid-market focus therefore gives it resilience. As one source puts it: "Others are fishing in the stuff that drops off in a bad year."

Even ignoring its target deal size, Houlihan vies with the biggest on the Street for the number of transactions it works on. Depending on the data provider, Houlihan ranks first or second for all US M&A by number of deals. For US sell-side mandates, which are its bread and butter, it is unmatched, topping the rankings in every year since 2014, according to Dealogic.

Playing in the larger pond of the mid-caps has other benefits too. The firm reckons that its target transaction size accounted for about 98% of US M&A transactions in 2020, for instance, with some 200 deals above that threshold and more than 11,000 below it. But the firm had a market share of just 3% of that sub-$1 billion group. It's no surprise its bankers think there is plenty of room to grow.

"We know we will never win every piece of business," says Beiser, "but we want to be invited to pitch anything that fits in our sphere."

Beiser argues that the diversification of Houlihan's businesses gives it an edge.

"For decades we have been focused on it, and it goes beyond simply having restructuring alongside M&A, although that is helpful," he says.

"Think about how the firm has been built – we are not captive to a handful of bankers; we are not captive to a handful of clients. We always look to be representative in good and bad markets, in as many industries as possible and expansive geographically."

And for the moment, Houlihan still faces relatively little competition from the bulge bracket, despite the talk of the big banks drifting down the size spectrum to get more investment banking bucks from the lower-earning lending and transaction banking relationships they may have had for decades. The reality is that clients with $1 billion of enterprise value are still below the radar of the biggest investment banking franchises.

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Scott Beiser, Houlihan Lokey

In any case, Beiser reckons the skills are different.

"In the true mid-cap space on sell-side mandates, you tend to talk to more would-be buyers – you are part-investment banker and part-counsellor," he says. "You are dealing with different individuals or family businesses. You might not have the same skills to walk into multinational public boards, but the needs of mid-cap clients are different."

Bulge-bracket financings can be more of a factory product, argues Scott Adelson, co-president of Houlihan and global co-head of corporate finance, who joined the firm almost as long ago as Beiser. "In the mid-cap private markets, financings are executed differently. We think we have the largest group of people focused on private finance in the world, and they not only understand their particular cog in the machine but the whole end-to-end financing solution."

Additionally, when deals get to a certain size, the ability to deploy a balance sheet becomes critical. Houlihan can't write those cheques. But what it can do is put its most senior staff into transactions for the kind of client that a bulge-bracket firm could only afford to handle with juniors.

And there are more of those senior staff than ever. Houlihan has about 200 managing directors in its corporate finance division, about 50 in restructuring and 40 in financial and valuation advisory. Excluding the GCA acquisition, managing director headcount has more than doubled since the financial crisis. Revenue per managing director – a measure that the firm's management particularly likes to linger over – has risen more than 80% since Houlihan went public in 2015, to $7.7 million.

"Houlihan Lokey has had a long history of a growth-oriented culture and organization, and we have demonstrated strong and consistent growth over time," says Adelson. "Corporate finance has been growing at a 20% compound annual growth rate for 20 years."

Houlihan's private equity and financial sponsor franchise has been critical to the firm's success and will be a vital part of tapping the vast potential that it identifies among its target market segment. Financial data company Preqin reckons that buyout firms have nearly $890 billion of dry powder.

"That community really started in the early part of my career, and now it is the most important provider of transaction impact today," says Beiser.

Private equity firms do more deals in the mid-cap space than in the large-cap: they need the volume of transactions, financing is easier to obtain and there are fewer pesky issues like antitrust to deal with.

One Houlihan banker estimates that sponsors drive perhaps 90% of deals in the mid-market. And the air is less rarefied, he says. In a competitive landscape that includes boutiques that often have narrow specializations, other independent investment banks that lack quite the same geographic scope and accountancy firms, Houlihan can stand out.

On top of that, investors are committing ever greater resources to the sector. In November 2021, the California Public Employees' Retirement System announced that it would be pouring more of its $495 billion portfolio into private equity, upping exposure from 8% to 13% and shedding equities and Treasuries to do so.

"Bear in mind that that is an organization that 15 years ago had just 5% committed to all alternatives, including real estate," says the banker. "As an asset class it's clearly here to stay."

For the last two decades or so Houlihan has had a dedicated effort to cover all manner of sponsors – it now has a team of more than 20 senior staff in North America and Europe that keep an eye on more than 850 private equity firms, 200 hedge funds and 80 family offices. They are not executing deals, but they bring in the people needed for each situation. Houlihan tops the rankings for US private equity transactions, ahead of the likes of Lincoln International, William Blair, Raymond James and Robert Baird.

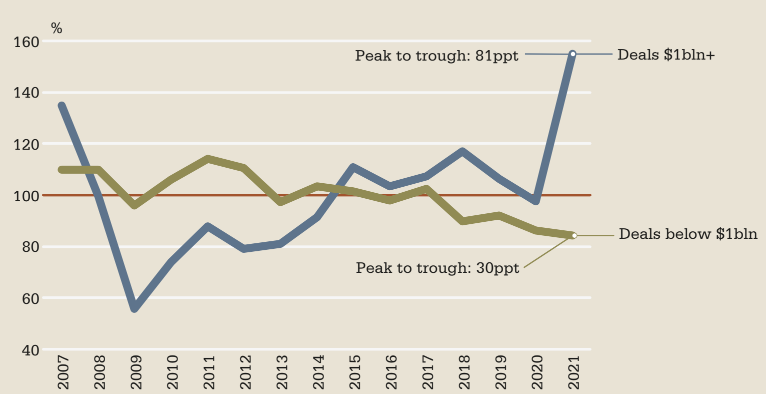
"What sponsors want is deal flow and information," says Beiser. "We do more deals than others, so we are going to be able to show them more opportunities."

Others put it more starkly.

> *"At other firms there can be real internecine warfare over fees – it is like a knife fight in a phone box"*
>
> A Houlihan banker

STEADY DEAL FLOW

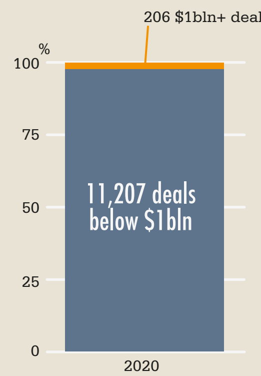
Number of global M&A deals, as % of 2007 to 2021 average by segment



Source: Dealogic

A NUMBERS GAME

Completed US mid-cap M&A in 2020



Source: Refinitiv, via Houlihan Lokey

"We have a list of 100 targets that some competitors wouldn't know how to spell. You hire us because we can give you access to them"

"We have a list of 100 targets that some competitors wouldn't know how to spell," says one. "You hire us because we can give you access to them."

Critical to the effectiveness of the sponsor coverage effort is the idea that it should be a shared resource for the firm rather than a fee event for individual bankers. It is now run by John Mavredakis, who has been at the firm since 1992 and is a former head of its investment banking operations. He works alongside Kevin Salmini, head of private equity coverage, and Mark Goldman, head of alternative capital coverage.

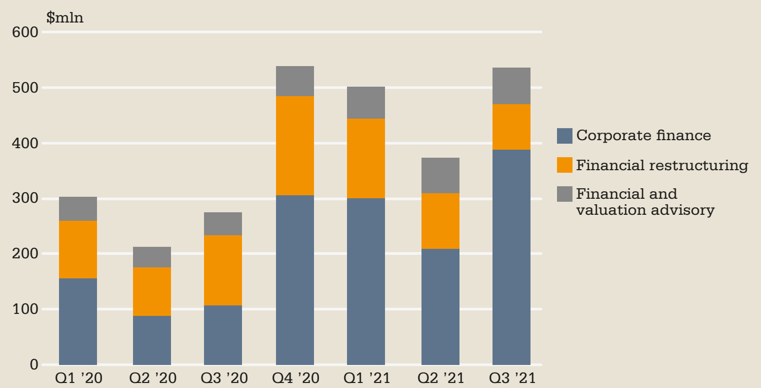
One banker at the firm says that his experience at Houlihan is in stark contrast to how sponsor coverage can operate elsewhere.

"At other firms there can be real internecine warfare over fees – it is like a knife fight in a phone box," he says. "But we are paid at the holdco level, by the corporate finance, restructuring and valuations teams at the end of the year."

And there is good reason to coordinate the effort: some 60% to 70% of Houlihan's revenues are linked in some way to sponsors. And as its bankers like to point out, every deal completed represents a potential return trip in three to five years, when the cycle must repeat if a sponsor's own investors are to be paid.

SHORT COVID

Houlihan Lokey quarterly revenues

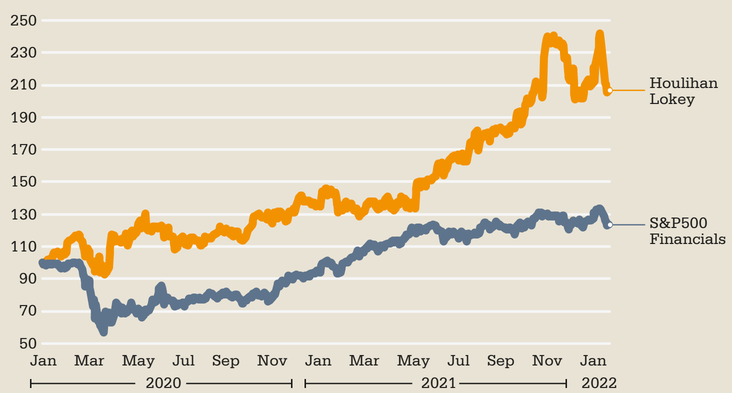


Note: data is for calendar quarters. Houlihan Lokey fiscal year runs April to April

Source: Earnings announcements

CRISIS? WHAT CRISIS?

Houlihan Lokey, S&P500 Financials, rebased Jan 1, 2020 = 100



Source: S&P Dow Jones Indices, Yahoo Finance

The relatively benign outcome of the pandemic, from the perspective of overall corporate distress, shows up in one obvious place in Houlihan's earnings – its restructuring franchise. Revenues have fallen consistently over the last four reported quarters, from $178 million in the last three months of 2020 to just $83 million in the third calendar quarter of 2021.

But while restructuring might not yet be the story of the coronavirus era, it doesn't mean it's no longer important at Houlihan Lokey. After all, the business still clocked up more than half-a-billion dollars in revenue in the firm's last fiscal year, about one third of the group's total revenues – and comfortably higher than that recorded in the two previous years.

And, as a key component of Houlihan's bull-bear model, it remains a vital hedge as the firm becomes more pro-cyclical when its corporate finance franchise grows. There is also a crossover effect: corporate finance business often emerges from the restructuring franchise.

Houlihan is the only firm in its peer group to break out restructuring as a distinct line in its earnings. That's no surprise: it is the global market leader and is unusual in having a large, dedicated team, which currently numbers about 250 bankers. And unlike other firms, they don't move between businesses depending on the cycle – they are always looking through the restructuring lens.

If the scale of the operation means that the firm is always working on situations, its breadth means that it can operate genuinely onshore. It does restructurings as a local player in markets such as Spain, Italy and

Germany. It has opened in Dubai and Singapore, where it was hired by Temasek to advise on a debt-for-equity swap for Pacific International Lines.

It has restructuring offices in London, Paris, Frankfurt, Milan and Zurich, as well as servicing Scandinavia from Germany. Its Dubai operation covers the Middle East and north Africa, as well as markets such as Nigeria and Ghana.

"Our size and breadth mean that we don't operate as fly-in, fly-out bankers," says Joseph Swanson, who is co-head of Houlihan's Europe, Middle East and Africa restructuring practice and co-head of Asia, having joined the firm in 1999 after nine years at Bear Stearns. "Instead, by having an onshore presence in the world's major restructuring centres, we can adapt global best practices to local requirements."

The firm has now garnered eye-catching mandates in China, advising on the biggest situations under way there, including Modern Land, China Evergrande and Kaisa. The GCA acquisition saw it add a Shanghai presence to its existing Hong Kong and Beijing teams. And with GCA's origins in the restructuring wave in Japan of the early 2000s, Houlihan now also has a substantial presence there.

Overlaid on its size and breadth is an approach to restructuring that looks different to some. The firm's DNA is in private capital markets, something that suits a restructuring franchise well, particularly when it is working with sovereign wealth funds or big family-owned companies in areas such as the Middle East, where legacy capital structures have created problems that now need to be resolved. Houlihan was mandated in 2020 to advise the Saudi Binladin Group on a multi-billion

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Change agents

One area where Scott Beiser, chief executive of Houlihan Lokey, sees encouraging room to grow is what he calls the "agenting" business for private debt. Once upon a time, selling your home in the US – and in many other markets – meant asking around to see who wanted to buy it or selling it to someone that you already knew wanted to buy it. But the real estate industry hasn't operated like that for a long time.

"Most people today would hire a real-estate broker to sell their home because they don't know who the best buyer is," says Beiser. "And about 75 years ago people started telling chief executives that they should hire investment banks to help them because they also won't know who the best buyer is."

But outside the public debt markets, which are generally available to the biggest companies, broking of debt financing has tended to lag behind. CFOs go to their local bank and thrash out terms. A private equity firm, while it might hire bankers to help identify buyers and sellers of a business, would typically consider that it knew where to find the private debt capital needed.

"That was before the great recession," says Beiser. "There were maybe 100 logical providers of debt capital then, but today there might be 1,000."

That creates a need for 'agenting' – an intermediary to sift through the options.

"When you don't know who is the best provider of that capital, that is good for the agenting business because we are in the business of maintaining relationships with hundreds of debt providers," says Beiser.

He thinks that outside firms such as Houlihan helping with private debt capital raising is still in its early days and the competition is still with clients who argue they can do it themselves. But even if they can indeed find the capital they want, he thinks that over time there will be a greater realization of the other benefits that can come from hired help.

"People might say: 'I can get a rate of X – if you can't beat it, why should I hire you?' But actually, it might be more about the terms, conditions and structure. Are they getting the best amortization schedule?"

Beiser goes back to where he says Houlihan's core area is: the mid-cap space. For financing of below $50 million it might be more logical to source it yourself, he concedes. For more than $500 million, the public markets might be the better option.

"But to source mid-market debt capital from the likes of credit opportunity funds, business development corporations or other alternative non-traditional sources, that is the strength of Houlihan Lokey, and it ties into the typical size of our clients," he adds. "You won't find the large-cap-focused firms doing this because they are interested in bigger transactions, and you won't find boutiques doing it because they don't have the depth."

That proliferation of new sources of capital – and particularly the explosion of the direct lending phenomenon – has had profound effects on how business is done. Beiser thinks back to how a firm like Drexel Burnham Lambert invented new ways to think about debt in the 1980s.

Drexel collapsed at the end of that decade but not without leaving the legacy of a continuing need to think in similarly creative ways now.

But navigating the new environment brings new challenges and new risks for those seeking capital.

"If you have only five logical firms who can provide what you need, it is possible they will say no," he adds. "If there are 500, then statistically – and either brilliantly or based on an alternative vision – someone will do it."

debt restructuring.

"Culturally, we don't come from the world of M&A," says Swanson. "We are more a hybrid of a lawyer and a leveraged finance banker. Restructuring is a different culture."

He argues that the firm's value-add is shown by its revenues, particularly in emerging markets where traditional investment banking work can be tough to make profitable.

"In cultures where advisory is typically not valued, we get paid a premium," Swanson says.

Covid might not have produced the wave of bankruptcies that was feared at the start of the pandemic, but it has changed the picture in certain areas. Before the pandemic, the business was idiosyncratic – sectors like shipping would periodically experience difficulties, but there were few common themes elsewhere. Covid has begun to change that in the hardest hit sectors, such as aviation, where Houlihan has worked with Virgin Atlantic, Malaysian Airlines, Garuda in Indonesia and NAC, the fifth-largest aeroplane leasing company in the world.

"The crisis led to a drastic reduction in profitability in certain industries, of which aviation is the most dramatic example," says Swanson.

The hotel sector benefits from high-quality real estate assets that can absorb more pain, and there are few takers for the equity needed to fund struggling retail businesses. But sectors such as aviation, operating with narrow margins and high leverage, are ripe for work.

Even so, the benign emergence from the pandemic continues to surprise.

"My thesis was that through the third and fourth quarters of 2021 we would see a big pick-up in default rates in Europe, alongside a general recovery in the corporate sector broadly," says Swanson. "Now we have seen that recovery, but we don't see the defaults – and it is a puzzle."

"We think we have the largest group of people focused on private finance in the world and they not only understand their particular cog in the machine but the whole end-to-end financing solution"

Scott Adelson, Houlihan Lokey

Houlihan's landmark strategic move in the last year was the nearly $600 million acquisition of GCA Corporation, a Tokyo-listed technology-focused investment bank. Although GCA is headquartered in Japan, half its business is in Europe, with the remainder roughly equally split between Asia and the US. The acquisition brought more than 500 GCA employees in 24 offices into Houlihan, including some 80 managing directors.

GCA had been on Houlihan's radar for some years before the firms embarked on the acquisition. The relationship dates to 2015 when the firm bought the investment banking operations of Leonardo in Europe, a firm that had an alliance with GCA at the time.

"[The acquisition] was a long time in the making and there were a whole host of reasons why it made sense," says Adelson. "As we began to understand how good a fit our cultures were, it became evident that it would be a good move. It gets us scale and critical mass in areas that we did not have before and sends out a strong statement in the very important sector of technology."

GCA was not exclusively a technology-focused franchise, but it was the firm's best-known area of expertise. That's useful, since Houlihan's presence in the technology, media and telecom sector was weaker than the market in general, as Beiser acknowledges. And it also helps that the bulk of its business was in sell-side M&A, in line with Houlihan's existing model.

"If tech isn't the most important industry today, then it is the second most important," he says. "But we were not classically in IPOs or a venture capital situation, and historically tech firms didn't go bankrupt because they didn't tend to borrow large amounts of debt."

And it is not an area for which firms can easily repurpose existing resources.

"You can't make tech bankers out of industrial bankers," says Beiser. "And now it is not just tech: there is infotech, healthcare tech, fintech, industrial tech. So GCA brought us more heft than we had."

And there was little overlap overall.

"You always hope that one plus one adds up to more than two, but the worry is always what you might be cannibalizing," says Beiser.

But with GCA, he says the fit has been excellent. "They didn't have a restructuring component, they did not have a dedicated calling effort with sponsors and were not in valuation, and they were clearly not as broad based in the US as we were."

Beiser knows that all that added value doesn't mean much without a cultural fit – he can't talk about Houlihan for long without returning to culture.

"A deal like this has to be with people that you get along with, with culturally similar DNA," he says.

While GCA has given Houlihan a leg up outside the US, its new owner was already pushing hard to expand its presence in Europe. But to do so has posed a different challenge to the trajectory that Houlihan followed in the US.

"There are still areas we can grow into in Europe, although we have made a lot of headway," says Beiser.

In the US the business became multi-industry focused, but Europe demands a more geographic lens.

"In the US it doesn't matter whether you have offices in one city or another, but you can't ignore the different countries in Europe," he adds. "There has been a learning mindset in the industry on both sides. When the Americans came to Europe, they learned that geography and language were important. The Europeans have learned that industry specialization also matters."

That's a point that others at the firm reinforce.

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Joseph Swanson, Houlihan Lokey

"It's all about deep domain knowledge," says one London-based managing director. "Our bankers are six inches wide and a mile deep, and that gives us real credibility."

The US is still by far the biggest market for all that Houlihan does, but that also pays dividends when it comes to expansion elsewhere.

"If you have a presence in Europe and can also tell the client that you have more connections than anyone else in the US, that is very helpful," says Beiser. "There are firms we compete with in Europe that don't have that kind of US option."

And expansion beyond its home market is an important part of Houlihan's strategy. Beiser talks of an ideal of half the firm's business coming from the US – in its last fiscal year the US accounted for nearly 80% of revenues. But, as he notes, "we don't want to get there by shrinking the US."

Beiser says that Houlihan's restructuring business was "the tip of the spear" in the way in which the firm has expanded geographically. After its earlier launch of a restructuring practice in Dubai, for example, the firm launched its first industry group in the Middle East in January this year, hiring Rouzbeh Fazlinejad, the former head of M&A at Berenberg, to run oil and gas coverage in the region.

Something similar is now happening in the firm's capital markets business, which is being bolstered with more dedicated coverage of financial sponsors in Europe, as well as building out its industry coverage groups.

In early 2020, the firm hired William Marshall to lead a new European equity capital markets advisory practice on the heels of rapid expansion of its debt capital markets capability in the region. In November, it appointed James Ireland, Guy Mullin-Henderson and James Sutch to build out its European business services group, also strengthened by a team of 11 coming in from GCA Altium, the European arm of GCA.

A slew of other acquisitions has also helped. The Baylor Klein deal in July 2021 was the firm's sixth in Europe in six years. In 2015 it bought McQueen, a consumer sector-focused boutique in London, and the investment banking operations of Leonardo in Germany, the Netherlands and Spain, establishing a joint venture with its

"The acquisitions in Europe have taken us from being nowhere to being an up and comer. We now have true scale – we are the second most active adviser in Europe"

Scott Adelson, Houlihan Lokey

business in Italy.

In 2018, it bought BearTooth Advisors, a New York and London-based adviser to alternative asset managers, which allowed Houlihan to establish a private funds group within its corporate finance unit.

In the same year it acquired data and analytics-driven advisory firm Quayle Munro in London, which it used as the basis for a data and analytics group within Houlihan. And in 2019 it bought Fidentiis Capital, a Spanish adviser focused on mid-caps.

That string of deals took the number of Houlihan bankers in Europe to 260, up from 80 in 2014, with 180 in corporate finance.

"The acquisitions in Europe have taken us from being nowhere to being an up and comer," says Adelson. "Together with the acquisition of GCA, it really changes the landscape completely. We now have true scale – we are the second most active adviser in Europe."

A world of increasing geopolitical strife, uncertainty over the direction of monetary policy and a still-fragile emergence from a pandemic – there seems to be no shortage of things for those running financial firms to worry about. But for Beiser, who calls himself "net bullish", it's the battle for talent that looms largest.

"I have learned over decades that there will always be geopolitical issues, and you just have to live with it," he says. "When things happen, on a relative basis it is probably better for us, because turbulence helps us. But what I always worry about most is how to avoid complacency in our organization."

That's because firms like his can no longer rely on being the unchallenged destination for bright talent emerging from business schools in 2022. When Beiser started in the business some 38 years ago the typical route was to get an MBA and then head to consulting at the likes of McKinsey or investment banking at the likes of Goldman Sachs. Now, partly because of the poor reputation of the finance industry post-2008 and partly because of the power of the technology sector and social media, graduates are more likely to want to head to Google or a five-person startup.

"There are probably more bright people around than ever and their availability around the world is better than ever," he says. "But stickiness and loyalty is far less than it was, partly because of those changes in societal attitudes and partly because there is a generation that has not lived through a recession."

It is a different world to when Beiser was one of just 25 comrades-in-arms at Houlihan. As they grow, financial institutions cannot avoid adding complexity, even when they are focused on intellectual capital, like Houlihan, rather than betting the balance sheet like the money centre banks. The nimbleness of the startup is difficult to maintain and Houlihan Lokey is no different in that respect.

Culturally, the firm clearly sits a little apart from some on Wall Street. One banker describes the vibe as more California than Manhattan, more T-shirt than brown shoes – although he concedes that Adelson probably owns a tie and knows for certain that Beiser does.

That vibe may play well to the younger crowd, but the fact remains that the generation that is now in the early stages of their careers has known nothing more than securing better prospects every time they move, which in turn encourages them to move. Unlike battle-scarred senior colleagues, they don't have the 'lived experience' – in the jargon of the day – of fearing the loss of their jobs at any moment.

Beiser reckons that experience will change at some point but remains confident of his firm's ability to prevail no matter what – not least because of its diversified business.

"We are not a fan of recessions, but some level of volatility is good," says Beiser. "It encourages people to hire us to help them and it will tip a few more into restructuring."

But he argues that there are few signs that an increase in distress will be enough to derail the wider corporate finance business where Houlihan is making most of its money.

After all, he notes, "we had a three-month downturn because of Covid, not a three-year debacle." EM