

THE U.S. PRIVATE CAPITAL MARKET: STILL “OPEN FOR BUSINESS” BUT WITH SEVERAL MAJOR ADJUSTMENTS

Now that we have all endured the last six months of stock market upheaval, with its successive waves of a downward credit spiral, followed by the severe liquidity crisis and now the increasing fears of a deepening recession, it is time to stick our heads, like the proverbial ground hog, out of the hole that all of this bad news has created to take a fresh look at just how hopeless or hopeful the next six months will be in the private equity and debt markets and the implications for deal-making.

Everyone concedes that the private investment industry may be in for a long period of adjustment, both in terms of the pace of investing and in the management of existing portfolios. At the heart of the current dislocation is the fact that lending has slowed to a trickle across most industries and markets, as commercial banks are reluctant to offer financing because of the widespread uncertainty about the length, intensity and consequences of the current crisis. This is posing significant challenges to the private equity sector, which has enjoyed strong growth over the last decade in large part because of unfettered access to cheap credit.

There is no doubt that the cascading effects of the financial crisis have left us all a little numb and undoubtedly prone to inaction and sitting “on the sidelines” until the worst has blown over. But, quite to the contrary, there are a number of rays of hope that some economic “corrective forces” have already begun to kick in or are about to take place that will ultimately lead to the restoration of financial market stability, and with it significant areas of opportunity, at least for those who are smart and agile about how to navigate the choppy waters still ahead. The first “corrective” force is, of course, the old adage that private equity investors tend to

see opportunity in adversity, and the current crisis is no exception. Many private equity funds are already opportunistically on the lookout for new investments outside of their traditional geographic regions and sectors. While the majority of these investors will stick with their traditional strategies, there is a significant number (perhaps as much as 30%-40% by one industry survey) who are ready to venture outside their usual comfort zone to seek deals in other sectors, other geographic regions and in different size ranges (mostly smaller, more doable deals). This flexibility will fuel a continuing level of fresh private equity investment even while the current downturn is playing itself out. Indeed, there are particularly encouraging signs of continuing levels of investment activity in certain targeted sectors such as healthcare, IT and telecommunications.

It should also be stressed that despite common perception, not all deal-making has ground to a halt. Many of the smaller-to-medium size deals are still finding ways to be completed, albeit with more risk-adjusted capital structures and at valuations that reflect the “new realities” imposed by the downward shift in public equities and the economic downswing affecting virtually all business enterprises. Despite the scarcity of bank debt and the rationing of what bank credit there is in the market, creative buyers are finding ways to work around these impediments to complete transactions. Thus, in the absence of plentiful or rationally priced bank debt, many transactions are being funded by various non-bank senior lenders as well as mezzanine investment funds, which have the flexibility to invest in mezzanine debt as a “surrogate” for traditional bank debt, perhaps with the goal of re-financing the higher-priced mezzanine debt in several years after the market turmoil lifts.

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The use of “stretch” mezzanine debt to supplement the availability of private equity and to provide a stronger “equity-equivalent” capital base for an acquisition has also expanded in recent months. The mezzanine funds which have the flexibility to take “equity-type” risk in properly structured transactions have seen their opportunity deal flow increase over the last 3-4 months, with some funds investing in “both” the equity and mezzanine segments of the deal capital structure for more investment return as well as greater control. At the same time, the target IRRs of some of these “stretch” mezzanine funds has increased from 17%-20% to a higher range of 23%-26%, moving their financial returns to a higher plateau to match their sense of opportunism. Also, despite a general “flight of capital” from some investment funds, those which have been able to expand their “franchise” in these difficult markets have actually been able to increase their LP capital and even start additional “opportunity” funds to meet the market demand. In fact, through the first 3 quarters of 2008 while fund-raising for traditional buyout funds has been flat, at the same time mezzanine fund-raising has soared with \$37 billion raised as compared with only \$3 billion in the year earlier period.

With credit lending drying up significantly, there has naturally been a considerable tightening of underwriting and credit standards by lenders who still showed lending activity to M&A deals. According to one survey, total debt-to-EBITDA declined to 3.1x in Q2 2008 for LBOs with less than \$50 million in EBITDA, down from 3.9x in Q1 2008 and down from 4.4x in all of 2007. Middle-market price multiples have also continued to drop from average levels of 2007. The ratio of enterprise value/EBITDA averaged 6.8x for Q2 2008, as compared to 7.6x for Q1 2008 and 8.0x for Q4 2007 and 8.6x for Q3 2007. Despite the influx of active strategic buyers entering the market and the accumulation of private equity money chasing deals, a number of market observers expect that the progressive slide in

price multiples will continue to drop by between 0.5x-1.0x for each of Q3 2008 and Q4 2008, until the credit market stabilizes overall. Against this backdrop, sellers will have to continue to adjust their pricing expectations to the new market climate.

Given the constraints of the market, there is obviously a significant new sense of caution among many investors in making new investments. Most private equity firms are intensifying their due diligence processes and applying much more conservative risk-adjusted standards to their scrutiny of prospective new investments. This caution also extends to adopting more conservative capital structures for investments. Many deals are seeing a larger percentage of equity or equity-related capital being put into the opening balance sheet of new investments, with the equity base sometimes extending up to 40% to 50% of the deal, depending on the industry and overall risk complexion of the specific investment. This fortification of the equity base of deal structures is not just to compensate for the relative scarcity of available debt capital, but also represents a genuine attempt to apply more conservative financial engineering to deal structures in a market climate where the perceived downside risks are more manifest. However, this reduced financial leverage results in more financial flexibility for the enterprise in case of an unforeseen development without the fear that the business itself will succumb to covenant defaults or difficult debt repayment requirements.

We are also finding that many private equity investors are targeting “recapitalization” opportunities in stable businesses with sound long-term strategies. These “recaps” allow the investor and the management team and/or current owners to “partner” together in a way that brings fresh capital to the operation, rewards the past owners for the success they have created in the enterprise, and gives both parties a meaningful stake in the business “going forward”. A number of “buy-out” investors are also making a stronger effort to

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encourage founders and senior family managers to have a continuing role in the acquired business, thereby sustaining some of the inspiration that originally ignited the development of the business itself. Such involvement tends to make for better continuity and to maintain the momentum of the enterprise after the investment is made. In many instances, investors are customizing the ownership structure so that the selling shareholders get to take some hard-earned cash “off the table” while retaining enough remaining equity to continue to incentivize the management team to continue driving the business. In a difficult economic climate, sustaining this type of continuity can make the difference between a successful investment and one that suffers disruption.

Another consequence of the slowdown in activity and the overall credit squeeze is that most private equity funds are paying much more attention to nurturing the investments already in their portfolios. With the public capital markets virtually closed to IPOs and debt capital very scarce, many investors are facing the reality that their existing investments will probably be staying in their portfolios for an additional one to two years until the markets stabilize. Accordingly, they are focusing on helping those portfolio companies “stretch” their existing capital by implementing cost reductions, improving productivity, and seeking new synergies. In fact, a number of observers believe that the days of robust growth in private equity investment has probably masked the under-performance of many of these portfolio companies. The current downturn is an opportunity to work with these companies to improve operations and increase the value of these investments prior to exit.

Despite this new effort toward more attentive portfolio management, many private equity firms are also continuing to explore new and some non-traditional “exits” for those portfolio companies which are capital constrained and which have little or no additional “runway” with which to mature in portfolio. For these companies, some

investment firms are looking to “partner” with publicly-owned strategic buyers in fostering a controlled sale to a strategically “good fit” company, particularly one with a good cash cushion and whose stock could benefit by the addition of improved outside technology to counter the downward pressures of the stock market on its publicly traded shares. These “marriages” are mutually beneficial to both the buyer and the selling investor. It often results in a “win-win” situation for the selling investor (who retains some ownership stake by holding the buyer’s improving stock) and the strategic buyer (which gains a much needed technology injection to improve its products and ultimately its competitive industry position).



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