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PRIVATE EQUITY

Structuring mid-market private equity transactions

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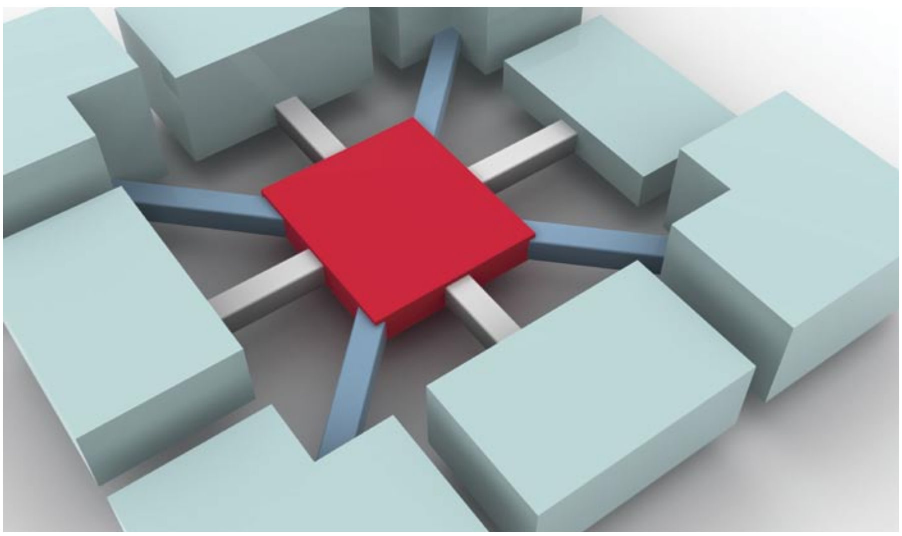

2007 was a tale of two halves for private equity. The mega deal boom of the first half of the year suddenly ran dry overnight as the summer's credit crunch increased the reluctance of banks to lend and reduced the volume and size of deals being completed. Acquisitions that had been closed in the second quarter were agreed at much lower valuations in the third quarter. A survey conducted at the tail end of last year by Financial News on more than 700 industry practitioners revealed that private equity firms are expecting a significant reduction in the returns they will be able to achieve in 2008, partly due to having to contribute more equity to their deals. Three quarters of respondents said they expected returns from large buyouts to be "somewhat lower" or "significantly lower" than last year, with nearly a third of respondents expressing the most pessimistic views. For mid-market deals, 39.6 percent thought returns would be somewhat lower in 2008 than in 2007 but 15.1 percent foresaw a rise. At the end of 2007, mid-market deals were dominating the acquisition landscape, but will the trend continue and where do opportunities lie? In the aftermath of the credit crunch and in the face of competition from cash rich sovereign wealth funds (SWFs) and strategic buyers, private equity faces a tough road ahead.

Yet experts agree that turmoil in the credit markets hasn't hit the mid-market as hard as it has the larger private equity deals. A reason for this could be that the mid-market never reached the very high multiples seen in the larger buyout market, where multiples reaches eight or nine times EBITDA. The mid-market never reached seven times EBITDA and as Patrick Hurley, managing director at MidMarket Capital Advisors emphasises, this formed in part, the safety net for mid-market deals. "The impact of the credit crunch on the mid-market, particularly lower mid-market, is nothing like the excruciating body blow dealt to the big deal market. In addition to lower levels of leverage, lenders in the lower mid-market looked to actual EBITDA rather than pro-forma levels that depended on contingencies. Senior lenders in the mid-market also take comfort from having half of the capital structure underneath their level of exposure even after working capital availability is fully drawn." Mid-market deals have increased in the last six years, from 5.7 percent of all deals in 2002 to 8.6 percent towards the end of 2007, according to Dealogic. Although the rush of mega deals over the last 18 to 24 months has led banks to work through masses of overhung debt and re-price their loan packages, mid-market deals are still being financed.

There appears to be a huge amount of volume in the mid-market, with boutique investment banks finding mid-sized companies and matching them up with private equity. However, it is an over-simplification to suggest that the mid-market will simply sail through the crisis. In the UK, for example, there are reports that some banks which used to wholly underwrite the debt and then syndicate it are no longer willing to do so, for transactions above a certain threshold. Instead, these lenders are forming clubs with other banks. For some mid-market deals, as many as four or five banks might club together, with each agreeing to take a portion of the debt in order for the transaction to proceed. Due to syndication risks and investor disinterest in leveraged loans, some UK banks are reportedly reluctant to take more than £150m on their books and will only lend if the syndication can be arranged prior to the deal.

In the current climate it is trickier for private equity firms to gain financing, but not impossible. Banks are under increasing pressure to put debt out to meet targets in the new calendar year, which means financing is available. But instead of talking to one bank, private equity firms may need to allocate time and resources to engage with three or four. In addition, the credit squeeze is causing downward pressure on transaction values, which will cause some prospective sellers to re-evaluate their strategy and make it more difficult for private equity to find willing targets. "It is clear that purchasers are returning to more conservative valuations and lowering the multiples used to calculate purchase prices," says Mark E. Thompson, a partner at King & Spalding International LLP. "What remains to be seen is whether the targets are willing to accept these lower valuations. We are now witnessing a disparity between buyers and sellers but the conventional wisdom is that sellers will ultimately be forced to accept lower valuations if they want to complete a transaction."

As valuations are reduced and private equity loses the advantage of high leverage multiples, the competition for deals will increase, as strategic buyers will become more competitive with funds. Strategic buyers often have the advantage of synergies with the target company and with a more level playing field, will have the opportunity to be increasingly aggressive in bids when competing, says Mr Hurley. "Our experience has been that there is a pretty level playing field when sponsors and strategic acquirers vie for targets with each fully understanding the others competitive nature. Financial sponsors are always cognisant of the perceived ability of strategic buyers to do whatever it takes to win and strategic acquirers acknowledge that in recent times financial sponsors have allowed investment bankers to run efficient processes." Experts predict that the percentage of the M&A market that strategic buyers represent will increase over the course of the year.

Due to the appetite of private equity firms to boost their portfolios, firms will attempt to stretch to upper mid-market and larger deals. In doing so, they will come into increasing competition with the cash rich SWFs of countries such as Abu Dhabi and Singapore, whose state-sponsored funds recently bought large stakes in Citigroup Inc. and UBS AG, respectively. SWFs remain untouched by the impact of the credit crisis. Backed by overflowing foreign reserves and the knowledge gained by observing methods used by traditional private equity funds to make strong returns over the last several years, they are increasingly looking at direct investments in Europe and the US spanning both the large and mid-market. "SWFs are already providing competition to private equity funds and corporate acquirers in the mid-market. Although the press headlines have highlighted the recent larger investments SWFs have made, and in particular the minority investments that they have been making in international financial institutions, SWFs are actively bidding on and winning mid-market transactions. As these funds become more sophisticated and experienced in the deal market they will have a major impact on the buyout market due to their lack of dependency on leverage and interest in long-term investment," says Mr Thompson. In November last year, the technology sector demonstrated its strength in the US M&A mid-market sector, led by the Mubadala Development Company's $622m investment in chipmaker Advanced Micro Devices Inc.

However, despite the change in pricing and terms on bank financing available to private equity firms, they will not lay down quietly. Over the years, funds managers have built the expertise to compete no matter what the market conditions. They are adjusting their strategies and re-evaluating their opportunities. There is no doubt that they have the buying power to remain a force in M&A; US private equity firms alone raised $302bn in 2007, which was almost 20 percent more than the previous year, according to Dow Jones Private Equity Analyst. Most of this will target leveraged buyouts, but around $45bn will focus exclusively on distressed opportunities to maximise returns in a more difficult business environment.

Also, since developed markets have been hardest hit by the credit squeeze, private equity firms are turning their attention to the broader global economy. They are raising funds and increasing their activity in a variety of sectors and geographical regions, especially in the emerging markets. According to the recent Financial News survey, the regions in which the largest proportion of respondents said they would be increasing activity next year are Central and Eastern Europe (CEE), followed by India, then China. CEE provides real opportunity for healthy returns from mid-market deals. In terms of liquidity, contraction of the debt markets is unlikely to affect deal flow in any material way, since CEE continues to enjoy strong GDP growth and offers significant cross-border M&A opportunities.

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The picture may prove to be different from country to country and sector to sector, but overall, the prospects for 2008 seem good. Although, there is a return to old-fashioned credit assessments, conservative structures and covenants, the emerging markets appeal to private equity firms due to less competition from other buyers, says Mr Thompson. "The globalisation of the buyout market means it is extremely difficult for funds to find deals for which they are the only bidder, turning to emerging markets can prove to be a less competitive and more profitable market. Emerging markets typically represent a higher risk investment to what many funds are used to, but the returns are often more attractive. As a result, we are seeing US and European funds look increasingly at Eastern Europe and into Russia. In addition, some funds are turning to the Middle East to search for opportunities." For private equity players, mid-sized, family-owned companies in emerging markets retain their charm. Although a liquidity crunch in the leveraged loan market could rule out big acquisitions in 2008, mid-market deals might be even more numerous in emerging economies which have been barely affected by the credit crisis in the West.

But even in established markets, acquisition opportunities will remain available. "Market conditions are healthy and the outlook is good for the mid-market and especially the lower mid-market. Business owners have more options than ever before and there are more potential buyers and recapitalisation investors. Those same owners are more aware of the market and more willing to participate in it. Much more capital will continue to be earmarked for financial sponsors. Those of us committed to the mid-market remain very optimistic," says Mr Hurley. Although the first part of 2008 will witness a decline in mega buyouts, mid-market deals will grow at a steady pace with banks clubbing together to finance deals. Private equity firms will have leveraged funding available even if constrained by the necessity, in some cases, of a syndicate being arranged prior to a deal being struck and the time consuming process of dealing with multiple banks. The trend towards mid-market deals in the emerging markets will gain momentum, particularly in CEE and Asia with opportunities for mid-market acquisitions arising from family-owned businesses and steady growth of GDPs. Strategic buyers will remain a force against private equity but with firms widening their focus of mid-market deals to an international landscape there should be plenty of opportunities for all. ■

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Patrick founded MidMarket Capital Advisors after serving as head of Fleet M&A Advisors Philadelphia office. He previously served as Partner and Director of M&A for Howard, Lawson & Company, which was acquired in 2000 through a series of transactions and became the M&A unit of FleetBoston's capital markets group. Patrick originally joined Howard, Lawson in 1979 and held positions of increasing responsibility. He holds an MBA from Drexel University, a BBA from Temple University and is a NASD Registered Securities Principal. Mr. Hurley is past Chairman (2006) of the Association for Corporate Growth (ACG) which has 10,000 members in 46 chapters throughout North America and Europe.