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No Big Deals

By David Snow

Speaking recently at an industry event in New York, Christopher O'Brien, head of direct investment for Investcorp, compared the progressively exuberant mid-2000s leveraged lending market to a comedy.

"There's these two guys. They're lenders," he said, setting the scene for a crowd attending a mid-market conference co-sponsored by consulting firm Arthur D. Little and Columbia Business School. The scheming lenders are devising ways to do more business with their favourite clients - LBO shops. "I've got a great idea," says one lender - the bank will remove covenants from its loans so that financial sponsors will not fret about leveraging up their portfolio companies to 10-times EBITDA levels. But what if some of these overleveraged companies default, asks the other banker? Another great idea emerges - we'll let the borrowers repay the loans using "PIK toggles"! But wait, what if the LBO firms can't square up the equity to do deals as fast as we'd like them to? Great idea number three - we'll lend them the equity, too! At this point, a real estate lender overhears the two and eagerly joins in the conversation.

The knowing laughter from the audience, many of them GPs, indicated recognition that cheap and easy leverage is a thing of the recent past, and that the financing market of the recent past was indeed comically cavalier about risk. Given that the conference was focussed on mid-market buyouts, however, it was clear that most in the crowd wanted to believe that the joke was not on them, but on the managers of gigantic funds, who were the primary consumers of PIK toggle products. O'Brien confirmed this binary view of the LBO market when he said: I wouldn't know what to do with a $10 billion fund if you paid me."

There are several well paid GP groups currently overseeing private equity funds of $10 billion or more which are pondering what to do now that the financing market for very large deals has come to a halt. To their investors and market contacts, they are expressing confidence that all the equity they have at their disposal can be shrewdly put to work in smaller LBO deals and in different types of investment structures. Some market sources, however, say that not every large LBO firm has the ability to successfully switch to a style of investment other than the leveraged buyout.

By contrast, in the mid-market, however defined, participants claim that LBOs within their original sweet spots are still feasible, but all parties to a deal are exercising extreme caution with regard to the health of target portfolio companies.

Big Drop

While almost every buyout firm is claiming to be "open for business" amid the wreckage of the credit crunch, the numbers tell a more nuanced story - there's a lot less business happening right now across the LBO market globally, especially on volume basis. This is especially true in the two biggest LBO markets, the US and the UK. According to Dealogic, after hitting a high of $117 billion in May of last year, buyout volume in the US has dropped dramatically, with total buyout volume of $8.9 billion in October, November and December, respectively. In the UK, Barclays Private Equity and Deloitte have determined that fourth-quarter buyout volume fell to £2.9 billion from £15.4 billion in the third quarter - a roughly 80 percent drop.

Just as the sheer size of some LBOs during 2006 and 2007 helped create a golden age of financial sponsor M&A, the absence of those scarily large deals best explains the steep drop in buyout volume in the second half of 2007. In fact, comparing deal volume of the sub-$1 billion market against the mega-deal market reveals that while smaller deals are down in volume, they have not been hit nearly as hard as have larger deals.

Larger deals are simply harder to do in today's market. In fact Christopher Behrens, a managing director in the New York office of private equity firm CCMP Capital says he sees something of a "break point" at the $1 billion line - his firm does deals above and below this marker. "Private equity buyers in the billion-plus transaction size are going to have to be a bit more creative in terms of gaining certainty on financing, as well as be prepared to absorb greater pricing and structural changes to their committed financings," Behrens says, noting that his firm has started to be more proactive in sourcing and clubbing together lenders on its proposed deals. "We've always had good relationships with ultimate holders of the debt securities, such as mezzanine funds, hedge funds or insurance companies - and we have been restarting conversations about doing direct placements with them. It's almost a throwback to a time when banks provided underwriting for senior but you had to go to direct lenders and put a club deal together yourself for the rest of the capital structure."

Behrens adds: "Over a certain size, and there's only so much financing that underwriters will want to hold and risk being able to sell down. There will be fewer participants up there until exposure gets reduced and managed through."

Brian Gallagher, a managing partner at Chicago fund of funds Twin Bridge Capital, says that his entirely mid-market roster of GPs has started investing again at a more typical pace following a decline in capital calls last year. "We always go into the holiday season fairly quiet, but things picked up a lot for us," he says.

That said, Gallagher says there has been a "flight to quality" by mid-market GPs, which are now more willing than ever to pay up, and spend a greater proportion of equity, for the top quality management and sound businesses. Amid the uncertainty "people are saying, 'If I'm going to pay a full price for an asset, I want to make sure it's a market leader'."

CCMP's Behrens echoes this observation: "As a buyer you'll need a pretty strong conviction about what you're going to do with an asset to get around the higher cost of capital."

Up in the stratosphere of the very largest private equity firms, the definition of "big deal" has been downsized, at least for the moment. Few know this better than Milton Berlinski, global head of financial sponsors at Goldman Sachs. "One billion to $10 billion is going to be the sweet spot, and very doable if they make sense," says Berlinski of the altered mega-LBO market. "For now, $20 billion to $40 billion deals are just not going to happen. The market depth is not there, and frankly most boards do not want to deal with the uncertainty of deals of that size."

Berlinski stresses that the financing markets for big LBOs have gone from "wildly attractive to attractive", with spreads between the yield on US treasuries and high-yield bonds still narrow compared with historic levels. In any event, Berlinski is advising his clients that "if something makes economic sense, you should over-equitise and refinance at a later point".

Large private equity firms also tend to have something that small buyout shops don't - the resources to do "creative" deals, away from the standard LBO. Berlinski says he's seen an uptick in his clients pursuing different modes of putting equity to work, much of it involving PIPEs and distress situations.

Some sponsors, however, are more flexible than others with regard to investment strategy, with flexibility decreasing as deals get smaller. "The further down you go, the more this becomes a meat-and-potatoes business," says Gallagher.

With smaller portions, and nothing else on the menu, some buyout GPs are simply going to have to get used to hunger.