

Private Equity—U.S.

Market Update Spring 2010



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The last five years have been a roller coaster for the private equity industry. The mid-decade credit bubble fueled a deal environment that ascended quickly and peaked in 2007 with just over 1,000 leveraged buyout transactions representing \$475 billion in deal value. Few suspected that the ride down would be so fast and harrowing! The worst credit crunch and recession since the Great Depression reduced leveraged buyout activity in 2009 to 530 deals with \$34 billion of transaction value, a decrease of 50 percent and 92 percent, respectively. The big question is what lies ahead—a relatively level track with a few twists and turns, another upward ascent, or another, albeit milder, dip?

Based on economic and credit market forecasts, most industry observers believe we are likely to experience a slow upward trend, but there are a number of factors that could have a positive or negative impact on the expected trend. Let's review some of the issues that are likely to influence the deal market one way or another over the next few years.

Improving Economic and Credit Market Conditions

Improving economic and credit market conditions are likely to have a significant impact. Economic growth, evidenced by positive GDP over the last two quarters, has certainly helped stabilize top-line revenue for many companies. While the improving economy is one reason for increased optimism, there are other contributors as well. Many companies have taken advantage of softening credit

markets to refinance, recapitalize, or extend payment terms from lenders. Furthermore, debt providers are more flexible in extending debt maturities and amending covenants and do not appear to be eager to realize losses on their books. Instead, they appear to be hoping for the best via a slow work-out process. With fewer realized losses, lenders are likely to look more favorably at new financings.

\$500 Billion Of Capital Is Available For Transactions

It is estimated that private equity funds have access to \$400 to \$500 billion of committed capital. At a 50/50 equity-to-debt ratio this equates to almost \$1 trillion of deal value. In fact, industry observers think that it may be difficult for some of the larger firms to deploy such a large amount of capital within their typical three-year to six-year investment period. However, if credit markets and purchase price multiples cooperate, it is likely that private equity funds will be eager to put this stagnant capital to work.

Middle-Market Transaction Multiples Have Fallen

The second half of 2009 saw falling multiples as owners of good businesses reconciled themselves to lower valuations. According to *Buyouts* magazine—companies valued between \$10 million and \$250 million saw trailing 12-month EBITDA multiples drop from approximately six times EBITDA to the low fives.

Regulatory/Public Policy Issues

The following issues are in play and may have an impact on the industry:

- ❖ **Carried Interest:** Industry observers believe the government is not likely to raise taxes on carried interest this year, but 2012 may be a possibility.
- ❖ **SEC Registration:** The industry consensus is the government will require private equity firms to register as investment advisers, which will create more regulatory oversight and higher back-office costs for private equity firms.
- ❖ **Volcker Rule:** Will the banks be forbidden from operating and investing in private equity firms?
- ❖ **Increased Capital Gains Taxes:** There is a strong possibility that Congress will increase long-term capital gains taxes from 15 percent to 20 percent, prompting some sellers to expedite a sale.

Significant Portfolio Company Debt Still Outstanding

The debt assumed in the credit bubble is expected to mature over the next five years. Moody's senior credit analyst, Kevin Cassidy, states that "an avalanche is brewing in 2012 and beyond if companies don't get out in front of this." More than \$700 billion in risky, high-yield debt will come due in a three-year period starting in 2012, and unless we have continued flexibility from lenders and improving economic conditions, some analysts fear this may overload the debt markets.

Overall, there appear to be more positive than negative signs for improvement; however, it is expected that a cautionary deal environment is likely to continue for some time. Whether driven by lenders or purchasers, we are experiencing far more detailed oversight and prolonged diligence periods. In fact, three quarters of the respondents to mergermarket's year-end survey indicated that they expected the level of importance that firms attach to the diligence process will increase given the current economic environment (mergermarket is an independent mergers and acquisitions intelligence service). Lockton's global insurance and employee benefits diligence team within the Private Equity and Corporate Acquisitions Practice (PECAP) have both the experience and capabilities required to meet an expected increase in demand and increased oversight from our private equity and corporate acquirers.