Clock Is Ticking on Private Equity's Dry Powder

Auto Supplier, Cross-Border Deals Likely in 2012

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Now that turnaround and finance professionals have lived through the credit crisis and are still around to talk about it, what's next? What do these professionals need to know to navigate the U.S. financing and capital markets in 2012? How will deals get done post-credit crisis? This article highlights some relevant and interesting market trends in these areas.

Banks make money today by not lending. Ever wonder why banks do not have huge lending appetites right now? While president of the Federal Reserve Bank of Kansas City, Thomas Hoenig said that the Federal Reserve's policy of holding interest rates near zero amounts to a subsidy for large banks that redistributes wealth from savers to debtors. Testifying before the House Subcommittee on Domestic Monetary Policy in July, Hoenig said banks can borrow at 0.25 percent and buy U.S. Treasury bonds that yield more than 2 percent.

"It provides them a means to generate earnings and restore capital, but it also reflects a subsidy to their operations," Hoenig said. "It is not the Federal Reserve's job to pave the yield curve with guaranteed returns for any sector of the economy, and we should not be guaranteeing a return for Wall Street or any special interest group."

With a "risk-free" return of 2 percent leveraged at 10 times, it is no wonder banks today are not aggressively making new loans.

As megadeals lose their lustre, middle market companies are becoming increasingly attractive. Private-equity investors are increasingly focusing their efforts on middle market companies. Investments in these companies demand less capital than larger deals and have greater flexibility when it comes to cashing out. This makes middle market investing particularly attractive at a time when money remains tight and fundraising is challenging in the wake of the recession and global financial crunch. The statistics bear this out: middle market deal volume is increasing, both in terms of the number of transactions and the dollar value of deals (**Figures 1, 2**).

It's blast-off time for investment bankers, private-equity professionals, and deal financiers/lenders. Companies have been hoarding cash for more than two years; however, inflation is on the horizon and cash will have less value. With the economy slowly turning around, companies are spending on acquisitions designed to move their businesses forward rather than protecting them against the woes of a bad economy.

Well-capitalized corporate buyers continue to seek growth, realization of synergies, and diversification through strategic acquisitions that expand their footprint and product offerings. The current U.S. private-equity overhang, or dry powder, stands at $477 billion. Since 2003, private-equity fundraising has been driven not by the supply of private-equity investments but rather by limited partner demand for private-equity investments.

The current overhang is unsustainable, given the nature of private-equity fund structures; firms lose the ability to invest this capital once their investment period runs out. At today's deal flow pace, it would take around five years to invest the current overhang, which means that private-equity firms must start investing now at a much higher rate if they want to invest their full fund (and collect the fees and carry on those remaining commitments). These private-equity firms will try their hardest to put this capital to use, which should result in a plethora of M&A activity.

Unitranche debt has gained significant traction with middle market borrowers. Unitranche debt provides borrowers with the benefits of flexible capital and a more efficient lending process that increases the speed with which borrowers can execute deals. Unitranche lending has become a common method of financing middle market companies, and many private-equity firms and lenders prefer unitranche debt over the conventional capital structure involving a senior debt provider and a mezzanine debt provider. There are fewer parties to deal with, no intercreditor agreement issues among lenders, and one set of rules and regulations for the company.

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Figure 1

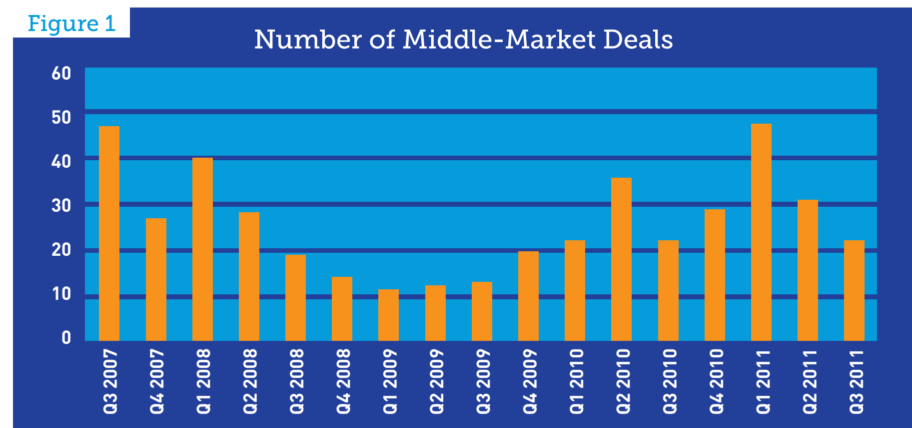
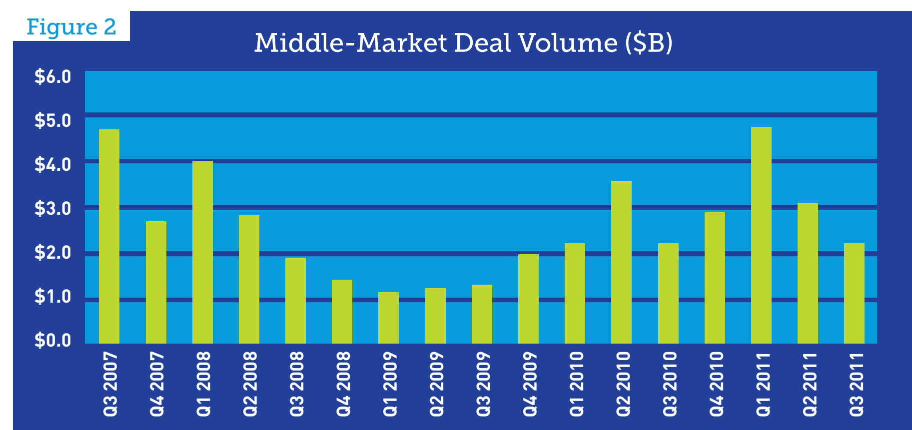


Figure 2



Source: S&P LCD Quarterly Review, Q3 2011

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Rather than having a separate interest rate for senior and mezzanine debt, the unitranche structure employs a single blended rate that averages out the cost of the two forms of capital. The simplicity of working with a single party can also help close deals more quickly, an attractive characteristic for firms that value ease of execution and speed.

Bank loan funds have been and will continue to be very popular with investors, which in turn has created a white-hot high yield market for large market companies. Between January and the end of June 2011, mutual funds registered inflows of more than $20 billion into leveraged loans, surpassing in just six months the $18 billion in total inflows recorded in all of 2010, according to Lipper FMI. The outlook for credit is positive, buoyed by strong corporate earnings and low default rates. A new crop of floating rate funds is aiming to take advantage of robust demand for bank loans as investors seek mid-single-digit returns and protection against an eventual rise in interest rates.

At least eight mutual funds that will invest primarily in senior floating rate bank loans were launched in 2011 or are preparing to launch, according to U.S. Securities and Exchange (SEC) filings. Bank loans are made to non-investment grade large corporate borrowers. Expectations of a future rise in interest rates, combined with a positive outlook for U.S. corporate credit, have raised the profile of bank loans among both institutional and retail investors. The floating rate aspect makes bank loans a natural hedge against rising interest rates and inflation.

Private-equity investing has become a much more difficult business this decade than it was in the last 30 years. From 1981 to 2000, the overall market maintained an upward trajectory, and the use of leverage made perfect sense during that time. In 1981, debt created returns because of the high-inflation environment, with interest rates that only moved lower for the next 10 years. In a sense, an investor could buy a business with absolutely no growth, leverage it with 90 percent-plus debt, watch inflation grow by 10 percent, and triple his or her money. That continued through the 1980s.

The 1990s were characterized by the greatest bull market of all time: from January 1990 to the end of 1999, one could leverage just about anything and post an attractive return. By simply levering the stock market, for example, someone would have been a leading fund manager. However, going into this decade of the 2010s, investors must navigate a choppy, up-and-down market and not rely on an up cycle to bail them out. With inflation in check, at least for now, private-equity fund managers will have to earn their stripes. It is now a full-fledged business as opposed to merely a form of finance.

Automotive suppliers are suddenly healthy and well-capitalized, making them ideal private-equity targets. The driving theme of the auto industry during much of the past 10 years has been survival. Those who managed to stay afloat did so largely by cutting back and eliminating underperforming legacy assets and overhanging liabilities. Market watchers are beginning to sense a renewed undercurrent of activity emerging among small and midmarket players who finally have some clarity regarding their business and the market at large.

In addition, a renewed sense of stability is also underscored by the revitalized balance sheets of the Tier 1 suppliers. Delphi, for instance, a year removed from bankruptcy, generated EBITDA of $1.4 billion in 2010 on $13.8 billion in revenues. TRW Automotive, Lear Corp., and Magna International, to name a handful of others, all sit comfortably, with cash positions well over $1 billion. M&A activity is strong in this segment, both among strategic players and private-equity fund participants.

Companies will need to do cross-border M&A. These days, most companies have some international component, whether it is customers, manufacturing, sourcing, or sales. In addition, with limited growth options at home, most companies will need to look to overseas markets to drive top line growth. Hence, more M&A transactions will likely have cross-border implications.

The Fed is closely watching leveraged loans. The Federal Reserve, which has come under heavy criticism for failing to spot the housing market bubble, is now paying close attention to run-ups in asset prices that could pose risks to financial stability. In early June, Fed Vice Chairman Janet Yellen identified one of the markets the central bank is monitoring the most closely: leveraged loans.

In a speech given in Tokyo, Yellen said the Fed is concerned that the large amount of money investors are pouring into syndicated loans has contributed to a rapid increase in purchase prices that could result in imprudent lending. Yellen noted that strong demand from investors has allowed borrowers to bargain for more attractive loan terms, "especially given that many funds catering to retail and other unlevered investors have little choice but to immediately deploy invested funds."

She cited as evidence "the re-emergence of deals that do not provide investors with the traditional protection of maintenance covenants—so-called covenant-lite structures—and of deals financing the distribution of dividends to equity holders, as well as a gradual increase in the levering of the underlying corporate assets by borrowers."

Yellen also noted that, prior to the financial crisis, lead arrangers of syndicated loans amassed significant pipelines of very large deals that they committed to finance. When investor interest waned, the banks were left with notable positions in "hung" deals, which resulted in substantial mark-to-market losses. When prices came under pressure, calls for additional collateral followed, in many cases leading to the sale of positions by banks and other market participants that put further pressure on valuations and started the cycle anew.

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