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Deal Volume Plunges But GPs Have Midmarket Hopes

Shasha Dai
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Buyout deal volume started out with a whimper in 2012 as economic uncertainty, particularly in Europe, dampened overall volume. But midmarket buyout professionals expect the year to end with more of a bang as institutional investors continue to hunger for yield and the appetite for acquisitions among strategic buyers grows.
"This is a very active time for us," said Terry Mullen , partner of **Arsenal Capital Partners** , a New York-based midmarket buyout firm. "There is a treasure trove [of target companies.]"
Overall 2012 global deal volume through June 30, however, declined by more than 26% to $62.5 billion from $84.8 billion, according to data provider Dealogic. In the U.S., the decline was much more modest, about 5.5%, to $35.9 billion from around $38 billion. The number of deals was down globally to 478 from 536, and dropped slightly to 207 from 208 in the U.S., according to Dealogic.
Market participants attribute the decline largely to uncertainty created by the euro-zone debt crisis, the slowing recovery of the U.S. economy and the coming U.S. presidential election. All of those factors put "psychological" pressure on the markets that is "impacting lending," said Howard Lanser, managing director in the mergers and acquisitions group of midmarket investment bank **Robert W. Baird & Co** .
"Although on paper there is significant liquidity in the system, lenders are not deploying capital as aggressively given the volatility in the market," Lanser said. "Every time we feel that we are gaining momentum, Europe seems to cause things to come to a stop."

A Tale Of Two Markets

Although overall deal volume dropped during the first half, most of the drop came at the larger end of the market.
According to Dealogic data, the volume of smaller transactions - those valued at $500 million or less - increased to around $6 billion from $5 billion. By comparison, deals worth more than $500 million declined to $29.9 billion from nearly $33 billion for the same period.
Midmarket firms also accounted for some of the most active firms on the deal front, stealing more of the spotlight from their mega-buyout brethren, according to Dealogic data.
Among the top 10 active firms this year, there is only one large-cap firm: **Kohlberg Kravis Roberts & Co** . By comparison, for the same 2011 period, three other mega-firms - **TPG Capital** , **Apollo Global Management** and **Oaktree Capital Management** - were among the most active, in addition to **KKR** , according to Dealogic.
Market participants say midmarket deals held up relatively well because they have historically relied little on the high-yield bond market for financing, and therefore are more insulated from the debt market turmoil caused by the euro-zone crisis. This is particularly true in the lower end of the midmarket, or deals valued between $25 million and $200 million, said Ted Koenig , head of midmarket lending firm **Monroe Capital LLC** .
"Companies in the lower midmarket have been largely unaffected by [the turmoil in] Europe and [slowing growth in] Asia," said Koenig. "There is more certainty and more stability, and therefore it is easier to pay multiples and easier to finance deals." Lower midmarket deals can be financed

by a single lender or a small club of lenders, compared with multiples pieces of financing, including loans and bonds, that larger transactions require, Koenig added.
That comment was seconded by Béla Szigethy, co-chief executive of Riverside Co., which focuses on small buyouts. "Financing is available for smaller deals," Szigethy said. "Larger deals are reliant on bond or note issuance that is sold into volatile markets." By contrast, smaller transactions are sold to "local bankers," he said. Riverside was ranked the most active firm this year by Dealogic.
Arsenal, also ranked one of the most active buyout outfits this year, was able to make deals at a crisp clip because it "honed in" on opportunities in three sectors: industrial, health care and financial services, "researching trends we can play, and what problems or issues we can help to solve," Mullen said.
The difficult macroeconomic environment sent companies looking for capital and international expansion to arms of midmarket firms like Arsenal, which has already backed its first deal from a new fund closed in April, he said.
Midmarket professionals remain optimistic about deal flow for the balance of the year and point to demographic pressures as more baby boomers look to retire, bringing companies they own to market ahead of anticipated changes in capital gains tax rates.
The additional taxes as a result of the health care law, which was upheld by the Supreme Court last month, are also expected to prompt business owners to sell, said Riverside's Szigethy.
The need to return capital to limited partners is also sending buyout firms for the exit, in advance of expected tax rate changes, said Lanser.

The Debt Conundrum
Of course, momentum on the deal side will depend largely upon improvements in the credit markets. This year through June 14, U.S. loan and high-yield bond issuance volume was down modestly from the year-ago level, to $338.1 billion from $398.6 billion, according to **S&P Capital IQ** LCD.
"The market tone has become more uncertain and activity has slowed largely due to the lack of a definitive solution to the European sovereign debt crisis," **Barclays** PLC said in a June 21 presentation. "Opportunistic issuers [of debt] are currently on the sidelines."
For 2012 as a whole, **Barclays** forecasts a high-yield bond issuance in the range of $200 billion to $225 billion this year, roughly on par with the 2011 level of $223.7 billion. For leveraged loans, the bank estimates that $300 billion to $330 billion will be issued this year, down from $373.1 billion issued in 2011.
Some buyout practitioners seem unfazed by the reduced debt issuance volume. Arsenal's Mullen, for one, said his firm has historically taken one to two turns less of debt than what is available. "For us, the [slowdown on the] credit markets is more a sideshow," Mullen said.
For others, the impact is being felt more in Europe. Riverside's Szigethy said that European banks are more reluctant to commit capital. Although the firm sees more potential deals in Europe than it did last year, he expects fewer deals to get through the finish line. Accordingly, Szigethy predicts that Riverside will invest 10% to 15% less capital globally this year than it did last year.
"When you have disruptions like that, it's hard to translate deal flow into deals actually closed," he said.
Although lower debt volume - in general - can dampen deal volume, one silver lining is that it can also keep a lid on pricing. According to LCD, purchase price multiples have come down over the post-crisis levels. This year through June 21, purchase price multiples reached 8.2 times earnings before interest, taxes, depreciation and amortization, the lowest since 2009,

when firms paid an average 7.7 times Ebitda, according to LCD. In 2011, an average of 8.8 times Ebitda was paid.
Multiples come down as deal size declines, perhaps lending some credence to the claims of small and midmarket managers that deals in their corner of the market tend to be less competitive and therefore less pricey. For deals valued at $500 million or higher, an average of 8.6 times Ebitda was paid this year, compared with 7.5 times and 6.6 times paid for companies valued $250 million to $499 million, and less than $250 million, respectively, according to LCD.
Koenig said that as deals get larger, competition heats up from strategic buyers, and it is easier to finance deals through the high-yield bond market. Both factors help push up multiples, he added.

2012	# of Deals	2011	# of Deals
Riverside Co.	8	Riverside Co.	7
Arsenal Capital Partners	5	TPG Capital	5
Grey Mountain Partners	5	Golden Gate Capital	5
Audax Group	4	Kohlberg Kravis Roberts & Co.	3
Platinum Equity	4	H.I.G. Capital	3
Sun Capital Partners	4	Apollo Global Management	3
Vista Equity Partners	3	CI Capital Partners	3
CapStreet Group	3	Water Street Healthcare Partners	3
Centerbridge Partners	3	Nautic Partners	3
Kohlberg Kravis Roberts & Co.	3	Oaktree Capital Management	3

Source: Dealogic

Uncertainty Overhang
Although midmarket professionals are hopeful about the second half of the year, there is plenty of uncertainty that could cloud their future, including potential recovery of the high-yield market.
The health of the high-yield market is closely watched by industry practitioners because it has historically been an important source of direct financing for large-cap deals. For midmarket transactions, though, few deals have been financed directly through issuing bonds, the bond market has been important for refinancing leveraged loans, as the alternative - the collateralized loan obligation market - remains largely shut. Issuers of loans therefore turned to the bond market for refinancing, thereby recycling liquidity into the midmarket.
If the euro-zone turmoil protracts, however, the recovery of the high-yield market would be hampered. "If the high-yield market is closed for an extended period of time, it will ripple down to middle-market lending." said Lanser.
For now though, however, some buyout practitioners remain optimistic.
"The world will continue to be chaotic, dynamic, volatile and low-growth," said Mullen. "Deals on the margin will be crowded out. But the high-complexity and low-growth…creates an excellent deal environment [for buyout firms]."

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