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INVESTMENT BANKERS

IN$IGHT
PERSPECTIVES ON THE CAPITAL MARKETS
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Private Capital Market Liquidity

Bankers and investors have money and are looking to make deals. But, how long will it last?

by Mark D. Working, Michael T. Newsome, and Jay Schembs

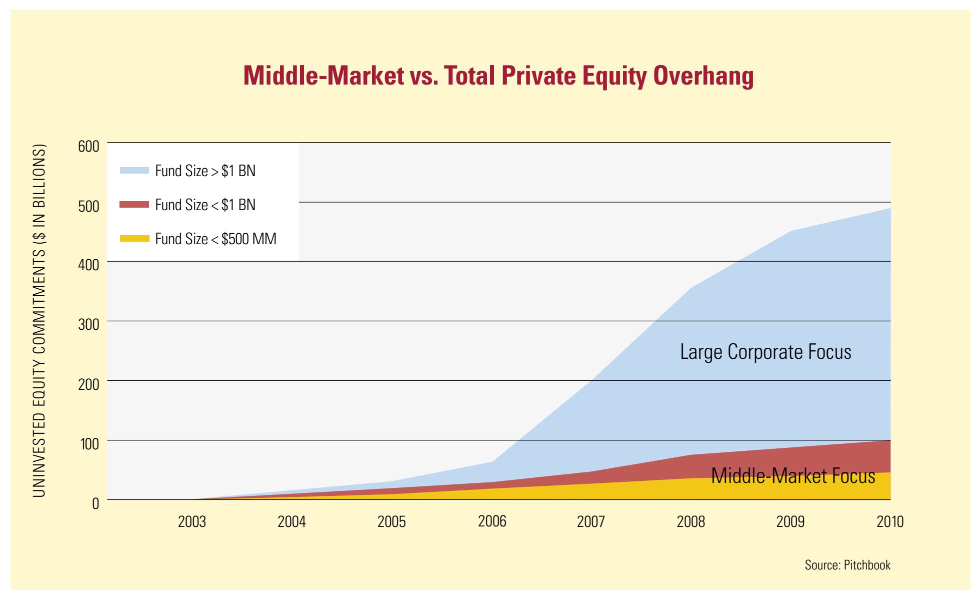
Over the past four years, the private capital markets have swung from massive liquidity and easy access to absolute shutdown, and back. In 2008 and 2009, it was a challenge to maintain or arrange debt financing or interest a private equity firm in a new investment. Today, we are seemingly awash in liquidity. The tidal flows within the capital markets have been dramatic and unpredictable. We have recent experience with bankers falling all over themselves to compete for loan opportunities, private equity firms bidding historically high multiple values, and use of investment structures that would be considered non-starters not so long ago. The market is continually changing and business owners would be well advised to take advantage of the conditions that exist today and recognize that the current accommodating investor/lender mood will not continue indefinitely.

Conclusions regarding the dynamics of the credit and equity markets are supported by inference to aggregate level data, but it is difficult to ascertain how, or if, that broad data applies to a specific market or situation. The intent of this IN$IGHT issue is to explore the dynamics of the changing markets, especially as they relate to middle-market mergers and acquisitions. Our interest is specifically directed toward privately held middle-market businesses and how they can best cope with the ebb and flow of market liquidity now and in the near future. It is timely, as we sense a resurgence of interest among private-company owners in monetizing their business holdings. Willing and able investors and lenders are a prerequisite to accommodate those desires.

PRIVATE EQUITY

The now familiar curve showing a nearly $500Bn private-equity "overhang" seems to be showing up everywhere, including in our most recent issue of IN$IGHT. Private equity firms went on a capital-raising frenzy in 2006 and 2007 and then found little opportunity to employ these new funds in the aftermath of the financial meltdown. The result has been an unprecedented buildup of unused equity commitments.

We decided to unpack these numbers in an effort to examine private equity availability for our middle-market clientele. The chart above segregates the capital supply "overhang" according to fund size. The top line in the graph represents the sum of all unused commitments for all private-equity funds. Funds of $1.0 Bn and less in commitments generally target middle-market investment opportunities. And, firms at the top end of this category typically seek to write equity checks in the range of $50-100MM per transaction. Only the largest privately held businesses in the Pacific Northwest would represent targets for these funds. More representative for the Pacific Northwest market are funds in the $500MM and less range, which include all of the private-equity funds with personnel in the Pacific Northwest.



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The chart on page one shows the middle market sub-components of the supply overhang, funds of $1Bn and less and funds of $500MM and less. Only 20% of the total overhang is focused on middle market size transactions, and about half of that amount is focused on the smallest transactions of the middle market. Accordingly, the current oversupply of capital devoted to investing in middle market companies is nowhere near as significant as for those funds targeting mega transactions.

In an effort to bring some perspective to the overhang, we made some rough projections of potential demand for middle-market

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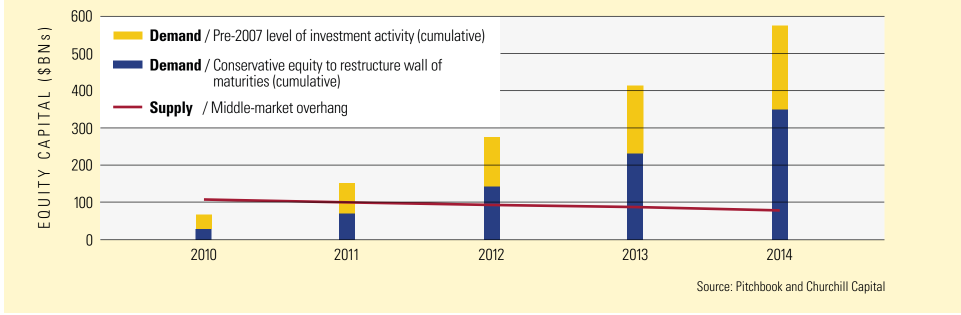

equity over the next several years. As shown in the above graph, we compared the unused existing middle market private equity commitments to two elements of demand: (a) the level of private-equity investment experienced prior to the investment bubble of 2006-2008, and (b) an amount of equity that may be required to invest in or acquire businesses that underwent leveraged middle-market acquisitions in that 2006-2008 period. As these leveraged financings mature, many of the underlying businesses will be sold or will be restructured with supplemental equity capital.

Contrary to conventional wisdom, the massive supply of private-equity capital focused on the middle market might not be that massive. Even if normal levels of liquidity

Projecting the timing of demand is a tricky exercise. The appearance of new opportunities will certainly drive private equity managers to raise more funds from investors. The point that business owners should take from this is that as opportunities increase for equity investments, the balance of power in pricing and terms shifts from the company to the capital supplier.

transactions are slow to return and debt maturities get pushed out, the well does not appear to be as deep as many think. Projecting the timing of demand is a tricky exercise. The appearance of new opportunities will certainly drive private equity managers to raise more funds from investors. The point that business owners should take from this is that as opportunities increase for equity investments, the balance of power in pricing and terms shifts from the company to the capital supplier.

CREDIT MARKETS

When the credit crisis gathered steam following the failure of Lehman Brothers in September 2008, capital became dear and the cost of credit soared. Since then, the larger U.S. banks have assiduously replenished credit losses with new capital. Among the 20 largest banks, $965 billion of fresh capital has been raised in the public and private markets. Thanks to this capital and a series of advantages conferred by the U.S. Treasury and the Federal Reserve, capital is no longer a constraint to the lending activities of larger banks.

Many community banks remain on the sidelines grappling with soured real-estate portfolios and are likely to require a couple more years to mend their balance sheets and consolidate. The big banks and fixed income investors are now more dominant than ever and display a renewed appetite for risk. Nowhere is this development more evident than the leveraged credit markets (high-yield bonds and institutional leveraged loans). Total year-to-date leveraged-credit issuance of $177 Bn is currently tracking 75% above first-quarter 2010 volume. Leverage credit issuance now seems poised to revisit the stratospheric levels experienced in 2006 and 2007, and the principal differentiating factor between today's market and 2006-2007 activities is the use of proceeds. So far this year, refinancing has represented nearly 70% of total new-issue volume. The second most prevalent use of

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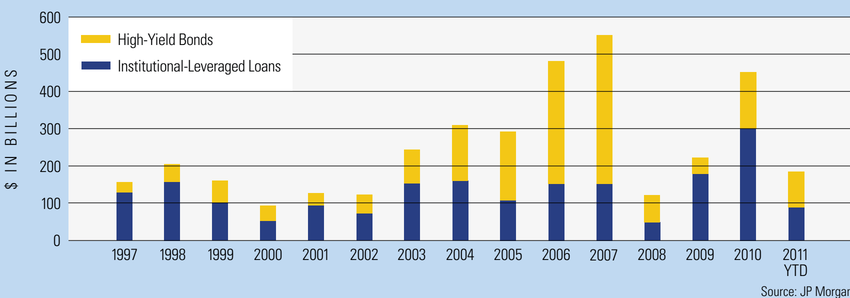
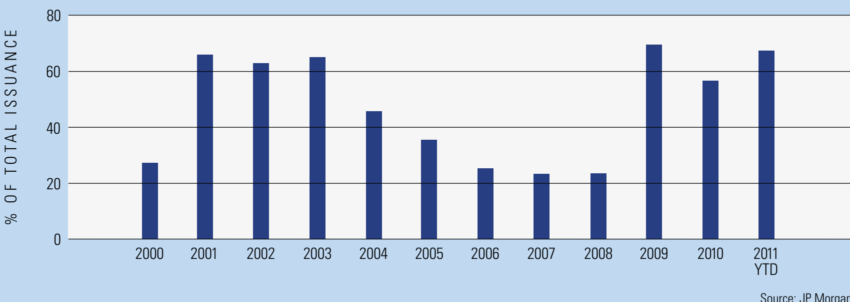
proceeds is to fund distributions to shareholders. By comparison during the 2006 and 2007 boom, refinancing accounted for a mere 24% of volume. Four and five years ago, leverage-enhancing LBO and recap transactions constituted about two-thirds of total activity.

With a surge of buy side demand, invariably credit terms are relaxed. Covenant-lite structures are back in vogue. Lower-rated (split B, CCC, and non-rated) issues as a





proportion of total issues is approaching the peak seen in 2007. In spite of this renewed appetite for risk, the fact that current proceeds are aimed at refinancing rather than ownership transfer or recapitalization transactions should dampen default risk over time.

By any standard, market activity is impressively robust. It is important to note that these developments should not be interpreted as a signal of economic vibrancy. Rather, activity is largely driven by the appetite of investors scrambling for yield among a sea of low-return alternatives. To get it, they are accepting more risk, all the while bidding that yield away in the heat of competition. This is clearly reflected in the nearby chart showing the spread between investment grade and high yield bonds over the past 13 years. Currently, the spread is 150 bps below the long-term average of 453 bps, which suggests that risk is now as cheap as it has been since late 2007.

At the same time, issuers are, for the most part, just trading paper from past deals with only a few objectives in mind:

1. Mitigating refinance risk by extending maturities out beyond a worrisome wall of maturities in 2013 through 2015, when credit may tighten;

2. Reducing the cost of capital and locking it in while lenders are accommodating; or

3. In select situations, taking capital off the table.

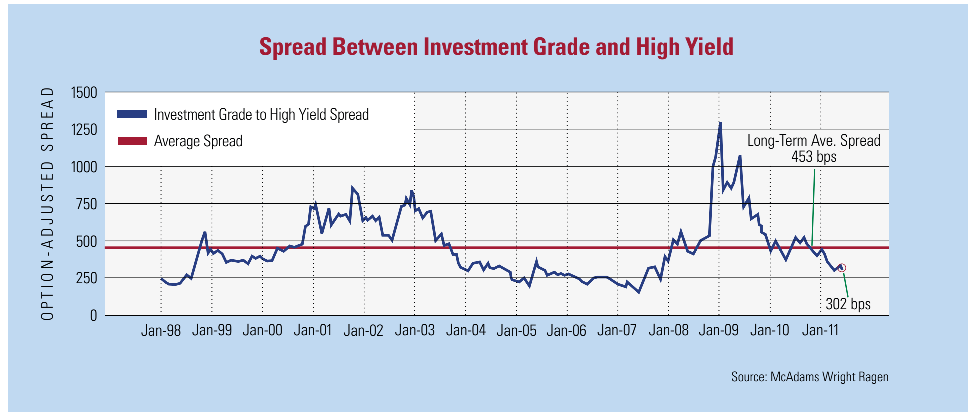
Business reinvestment and expansion of productive capacity is slack and does not appear to be a meaningful contributor to the strong tempo of activity in the credit markets.

Our clients don't often have access to public debt markets. Rather, they are primarily users of bank or commercial finance company credit and, occasionally, mezzanine structures. Nevertheless, public market trends often portend developments in the bank market. The larger banks are already plying a similar track to bond buyers.

In our middle-market world, demand for credit remains quite weak. That fact has been confirmed in conversations with bankers at regional and national banks. Clearly, economic activity has picked up since the official end of the recession in June of 2009, but this recovery has been vexingly tepid relative to past rebounds. The modest uptick in commercial and industrial credit some banks reported in the fourth quarter can largely be explained by the seasonal restocking of working capital (receivables and inventory) from the barren levels reached in the prior year.

The real driver of credit demand is GDP growth, which stimulates expansion capacity. As illustrated in the adjacent chart, loan growth tends to mirror the trend in capacity utilization. At approximately 75% of utilization, the economy doesn't yet need additional capacity and that translates into soft demand for commercial credit.

In an environment where few borrowers need incremental credit, bankers' focus shifts toward gaining market share—the effort to move Bank X's better customer (or perhaps even a marginal one with a hint of promise) over to Bank Z. Relationships are being traded back and forth at lower prices.



Credit market froth has steadily increased to the benefit of companies that navigated the downturn reasonably well. All of the elements of lower pricing of risk are present. Credit spreads have shrunk, maturities are being pushed out, and greater cushion is being negotiated into covenants. The one surprising development is the transformation of credit-hold limits, which can best be described as the amount of exposure a bank is comfortable holding for a single borrower or in a specific deal.

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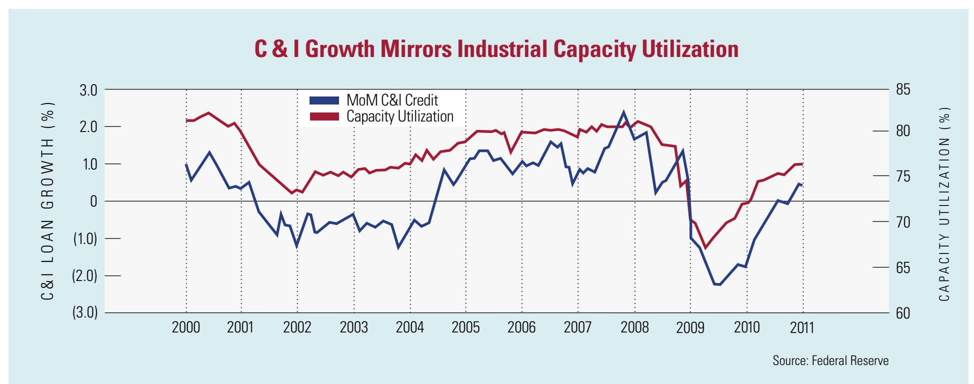
Bankers have let their corporate and private equity customers know that they want asset growth and pricing is not an obstacle. A process that stokes competition among lenders invariably leads to better results. Until business activity absorbs current capacity and triggers demand for external capital, excess bank liquidity is likely to keep the big banks competitive to the benefit of middle-market borrowers.

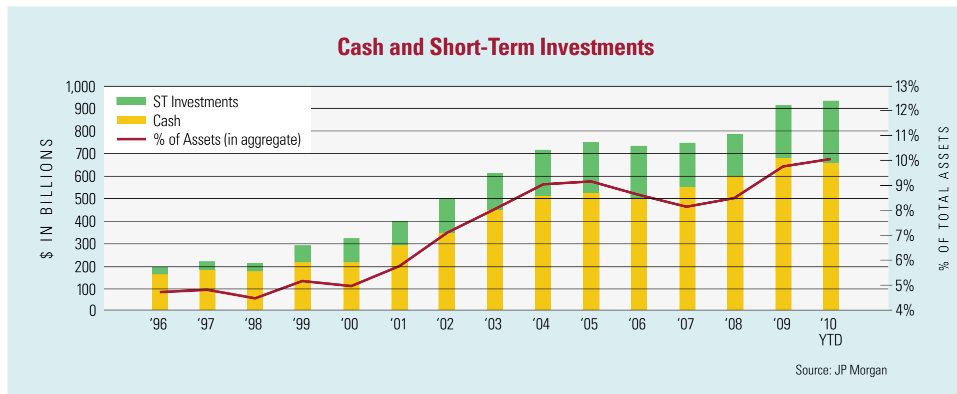
CORPORATE APPETITE

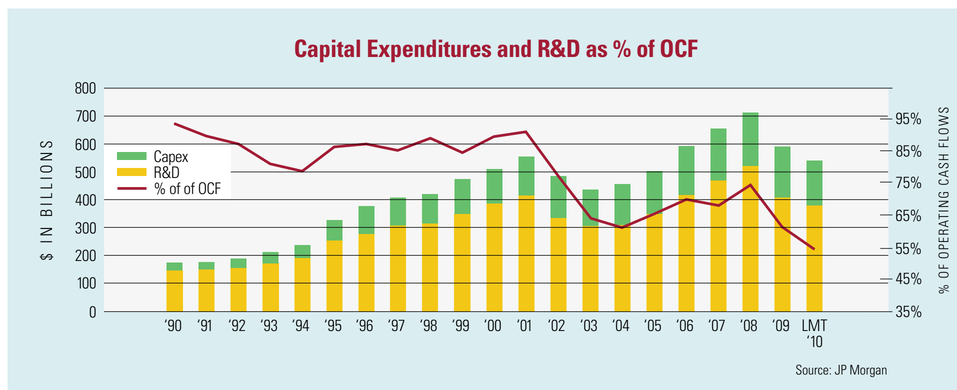
Corporations have been building cash and have now accumulated the most significant reserve of liquidity ever observed, estimated to approach nearly $1 trillion, or 12.5% of total balance sheet assets. This is a remarkable war chest with which to pursue acquisitions. Obviously, cash is held on corporate balance sheets for a variety of reasons other than ac-



quisitions, such as dividends, stock buybacks, and debt retirement. Historically, a big driver of corporate liquidity has been uncertainty and a perceived lack of investment opportunity. One important factor hidden in these gross liquidity numbers is the portion of corporate cash that resides in foreign subsidiaries and affiliates. It's not clear just how much cash is held overseas, but it certainly amounts to hundreds of billions of dollars. The principal hurdle to repatriation seems to be U.S. tax law.

The adjacent chart shows that corporate commitments to capital expenditures and research and development, the drivers of growth, fell off in the early part of the century after the tech bubble exploded. There was some growth between 2003 and 2008 from projects already in the pipeline. However, in the last two years, further contraction occurred at the same time that mergers and acquisitions activity hit a low point.





> **Corporations, on the other hand, have built cash positions primarily for safety. And although acquisitions might play into a particular company's strategy, we suspect that business logic will weigh heavily on investment decision-making. The cash might not be burning a hole in their pockets. And, as we have seen, some of the pockets are offshore and not readily available for domestic transactions.**

Heightened levels of uncertainty are always a damper to the risk taking that is inherent to aggressive acquisition strategies. Recent surveys of corporate executives suggest a rebound in optimism and, therefore, appetites for deal making, but this market has not yet found its way back to pre-crisis levels.

TAKE ADVANTAGE OF THE CURRENT ENVIRONMENT

Banks, private-equity funds, and corporate balance sheets are awash with liquidity. Collectively, they are anxious for opportunities to compete to put money to work on terms favorable to capital users. That being said, there is a reasonable prospect that the current oversupply of bank and equity capital may prove short-lived as new transactions and the refinancing of old ones will draw on this supply.

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Middle-market business owners are wise to recognize that market dynamics are not tied to their personal time schedules. Current market conditions are quite favorable, but it is unclear how long these conditions will last. The business that needs, or will need, liquidity should reach out to the market now. Owners contemplating ownership transition will find a welcome reception from a wide range of financial and corporate buyers. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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