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INVESTMENT BANKERS

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2011 Outlook for Private Equity

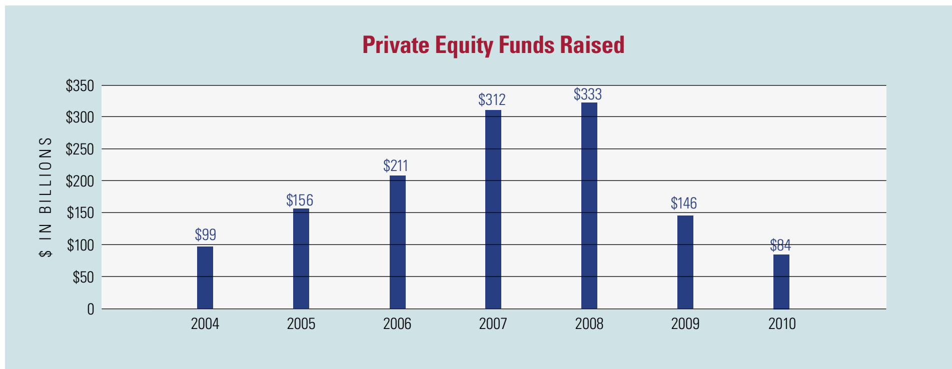
Market conditions have improved and private equity is in a scramble to deploy capital.

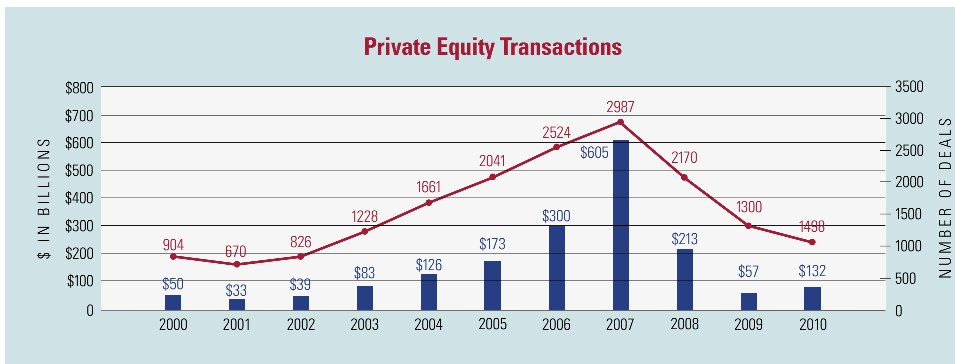
by William S. Hanneman

Virtually all forms of private capital scurried to the sidelines during the financial crisis and private equity was not an exception. Although private equity investors had raised considerable sums to pursue buyout transactions, this money largely sat on the sidelines during the past two years as sponsors found themselves in daily attendance at their portfolio companies and engaged in hand-to-hand combat with their lenders over existing portfolio financings.

Given the tight credit markets, on which private equity funds rely to finance acquisitions, exacerbated by declining demand across vast segments of the economy, the mergers and acquisitions market was virtually shuttered for the past few years for all but distress situations. The compression of revenue, cash flow, and valuations caused sellers to back out of the market as visibility into the future became increasingly murky.

The subsequent effect on the private equity industry was that the outflow of funds into new investments lagged the inflow from new fund raising, which has now created the largest backlog of private equity capital in the history of the industry, currently estimated to be in the range of $450 billion.





CASH, CREDIT & CONFIDENCE

Then, in 2010, a strange thing happened. The economy began to grow (however anemically), business volume stabilized, and cost structures were realigned to fit the new environment. Confidence, that sometimes-fickle state of mind, began to rebound.

The thaw in the financial markets was first evidenced in the public credit markets. Faced with anemic returns on other financial assets, creditors have been quite happy to offer funds for public and private companies to reload on leverage. In 2010, corporations flooded the bond market locking in low rates and stretching maturities. Private equity-backed companies raised a hefty $40 billion of cash in the debt markets in order to rake off rich dividends from the businesses they control. Recapitalizations, designed to provide liquidity to private equity investors, became a driving theme in the industry, resulting in a growing number of private equity-to-private equity ("secondary") sale transactions.

Although still far off its peak in 2007, deal making again began to improve in 2010, up 15% in the US and nearly 25% globally, fueled by bountiful conditions in the credit markets, record amounts of cash on company balance sheets, and gains in the public equity markets. A significant proportion of the transactions were purchases by strategic buyers who discovered that acquisitions were the best option for growth in the face of a stubbornly slow recovery, as well as private equity firms that have been under pressure to show some gains to their limited partners.

The improved conditions nationally are also being felt in the Northwest where private equity deal making is also beginning to rebound. While still off its peak of 178 transactions in 2007 in the Northwest, at least the number began growing again in 2010.

We, too, are feeling the thaw. Our phones began ringing at a higher frequency in 2010 with calls from private equity investors and from business owners interested in evaluating the market. It is clear that private equity is in a scramble to deploy capital before commitments expire. The messages have been that pricing will be aggressive, transaction structures are flexible, including the willingness to invest in minority positions, financing contingencies can be eliminated, and due diligence can be completed quickly. For those of us struggling in the trenches these past few years, this is all welcome news.

VALUATION

Business values have everything to do with future expectations. The drop in demand for goods and services in the economy during the recession, exacerbated by the lack of capital, caused business values to fall. At first, it was a widening of the bid—ask spread, as sellers held on to notions of what their companies used to be worth and as buyers' expectations

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of the future were tinged with pessimism.

Because of poor data quality, we have always been a bit skeptical of published private market valuation statistics. Dipping into the recession, those statistics showed that valuation multiples declined by a turn or two of EBITDA, which is in line with our notions. When combined with lower financial performance, it is no wonder that prospective sellers held off.

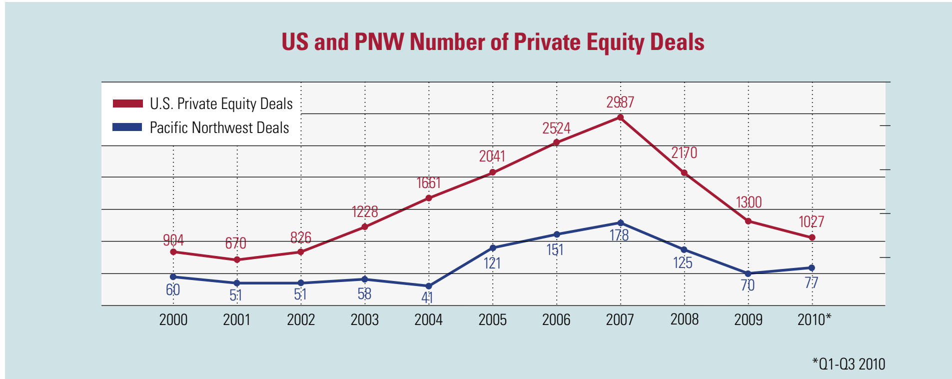
Our recent experience is that valuation multiples are beginning to rebound, particularly for companies that have continued to perform well during the economic downturn. Companies that were successful in dialing back their cost structures in concert with declining revenues and are again growing are also beginning to command healthy valuation multiples. It is uneven, depending on the industry, but sellers are cautiously coming back in to test the market and are generally pleased with the valuations that are being discussed.

WHAT WE EXPECT IN 2011

As we move into 2011, we are feeling the early winds of change, finding ourselves fielding many more calls and seeing much higher quality opportunities than over the past couple of years. A continuing theme is industry consolidation. Strategic buyers are coming back into the market to acquire complimentary businesses and consolidate capacity in certain industries. Private equity also sees opportunities to put capital to work in support of similar efforts.

As a result of a firmer grasp on future expectations, personal circumstances, recognition of the abundance of investment capital, or all of the above, owners of private businesses are beginning to investigate recapitalizations, minority equity investments, and outright sales.

With confidence continuing to build through the course of the year and ample liquidity, 2011 will be the first in a number of years for owners to seriously consider their options for liquidity. Consideration of a liquidity transaction should happen long before the event to give time to plan for and determine the optimal transaction, parties, and process to maximize the results. ❖



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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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