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Credit Crunch

Private equity managers have been riding high on the hog for the last few years and the first half of 2007 proved to be no different. All of that seems to have predictably come to a halt in the last two weeks, as the credit market is seemingly putting the clampdown, if not the smackdown, on the asset class that has propped up the stock market for so long. Many critics have warned the good times of fast and easy credit would eventually end and they appear to have been right with the subprime mess being the catalyst to banks tightening their purse strings.

To be sure, there is still a lot of money out there in the private equity market. Lest anyone think the asset class is going to wither and die, investors should expect to continue to earn quite a bit of money. Profits may not be as high in the near future as they have been in the recent past, but managers and investors alike should still expect their coffers to be full.

"Right now, deals that are going for eight or nine times EBITDA may get back to the six or seven times EBITDA world that we are used to," says Tom Bonney, a managing director with CMF Associates. "Those are deals that are still very easily fundable."

Bonney, whose financial consulting firm advises a number of private equity firms, likens the changing private equity market to the oil industry. He says that while the price of a barrel right now is between $70 and $80, even if the market dropped to $50 a barrel, oil barons would still be very happy.

Bonney is not alone in his assessment of a return to normal levels within the asset class. Timothy Mahon, a principal at Anderson Economic Group, says the market is finally starting to even out.

"The numbers are not getting crazy [low]," says Mahon. "They are getting to where you think they should be."

Mahon predicts the pace of deals will slow a bit as private equity firms will have to

work harder to prove to banks they are capable of taking on large sums of debt. Whereas many firms recently have had enough cash on hand to finance deals, most figured why should they spend that money when they could borrow it cheaply and use that extra money on other transactions to earn even more money. With the well starting to dry up, Mahon says there is going to be a return to when cash was king.

“I think we are in for some interesting times,” says Lorie Beers, a managing director at KPMG Corporate Finance. “What is happening in the credit market will change the dynamic of how these deals get done.”

Beers, who handles distressed mergers and acquisitions as part of her firm’s special situations and advisory group, has been forecasting the credit crunch for some time now. One of the effects of this credit crunch, she says, is that in addition to firms joining forces in club deals in order to pool their capital and credit together to complete mega transactions, the quality of the club will increase. Lenders will have to be more selective in their investments while the firms will also have to be more discriminating when it comes to teaming with fellow investors.

Mahon agrees, saying that if firms want to get in on a transaction with fellow firms, they will have to show their outfit is strong enough to bring in a certain amount of debt and a certain amount of cash the deal.

Mahon also points out that it could be a field day for those firms that have been managed in a way to anticipate the oncoming credit crunch. Bargains will abound.

“Firms that were run well enough to still have some dry powder will swoop in and get some good deals,” says Mahon.

Bonney thinks this is especially true for middle market firms. Prices will come down and buyers will come in. Although he does not have any empirical evidence to predict how much prices will drop for portfolio companies, he suggests a pricing correction of anywhere between 20% and 30% will result from the current conditions in the credit market.

The next question, of course, is how long will the credit market crunch. Mahon points out that August is typically a slow time of the year for private equity to begin with, but he says things should shake out in the middle market by the fourth quarter or the first quarter of next year. **Bonney suggests mega deals will slow down significantly in terms of volume and prices for the next six months to 12 months until the financing community can get their arms around the new math that will now price these deals.**

To be sure, it is not all gloom and doom. Mahon also makes the point that the global market continues to be frothy and there is a considerable amount of money in the marketplace that has been committed by limited partners. This will be deployed and the cycle will continue.

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