

Private equity contraction: a coming reality.

By Andrew T. Greenberg

Private equity industry consolidation has been a growing topic of conversation in middle-market M&A circles. Due to a combination of forces that have been gaining momentum, 2010 looks like the year that consolidation moves from cocktail party scuttlebutt to reality.

Given the strength and pervasiveness of the following pressures, it is not unreasonable to expect the number of North American private equity firms that obtain their capital from institutional investors to reduce by half over the next several years:



1. **Depressed deal flow.** GF Data Resources, the M&A data venture Graeme Frazier and I run, has collected data from 130 private equity groups on deals they've completed in the \$10-250 million value range. Our contributors closed 38 transactions in the first nine months of 2009, which annualizes to 51 for the year. This same group of private equity firms completed 155 deals in 2006, 173 in 2007 and, as the market softened, 120 in 2008.

As 2009 comes to an end, there are modest signs of improvement in debt availability and deal activity, particularly on larger transactions, but we expect that it will be 12-18 months before volume returns to pre-downturn levels. Institutional investors in private equity firms will not wait that long for their money to be put to work.

2. **More selective fundraising environment.** A year ago, as the stock market approached its low point, there was a lot of talk about the so-called "denominator effect" compelling pension funds, endowments, and insurance companies to shift money out of alternative investments like private equity to rebalance in the wake of losses in public equities. It now seems clear that this effect was somewhat overstated, that many institutional investors held their fire in rebalancing and then the need to do so was substantially reduced by the rebound in public stocks since last spring.

Having said that, there now is substantially less money flowing into private equity. Grant Thornton LLP and the Association for Corporate Growth reported earlier this fall that by mid-September 2009, private equity funds had raised only \$36 billion, compared to \$264 billion raised in all of 2008. Thus it would seem that the investor selectivity anticipated at the end of 2008 is now here in full force.

3. **Continued challenges in obtaining leverage.** The middle-market lending environment is far from normalized. GF Data Resources reports that senior and total debt averaged 1.7x adjusted EBITDA and 2.5x, respectively, in the first nine months of 2009. Senior and total debt levels were 2.8x and 3.6x in 2007. Again, while there are some signs of a thaw in these glacial conditions, bank lenders show every sign of remaining cautious, and that means financing risk will remain a concern for business sellers and their advisors. This will benefit large, active groups, like Audax Group and the Riverside Company, with deep asset bases and lender relationships.
4. **Greater consideration of resale value in secondary market.** The secondary market for limited partnership interests has continued to explode this year, and now is estimated to exceed \$20 billion. The reputation and investment record of the original sponsor shouldn't matter in valuing a collection of fractional business interests, but just as prestigious automobile brands hold their value better on resale, the secondary market is likely to make some marginal presumptions about the quality of the businesses assembled by the best-known private equity groups.
5. **Prospect of higher administrative/regulatory costs.** Over the next few years, the private equity industry is likely to face increased costs due to some combination of greater accounting oversight, taxation and government regulation. Whatever specific policy changes materialize, these costs will weigh more heavily on smaller firms, and will provide another advantage for entities able to bring some scale to these new obligations.

The private equity landscape won't change in a year, but these are the changes that seem likely over the next two or three years:

1. More deals will be completed by larger funds or complexes of funds with established track records, lender relationships and scale.

2. Nimble and resourceful firms based on other business models will be able to exist alongside these goliaths:
 - Small and mid-sized firms with well-developed areas of industry specialization
 - Generalist firms run by individuals closely identified with superior results
 - Family offices and other investors not dependent on institutional investor bases

3. Sponsors will continue to operate and even expand their own deal origination efforts, but it will make good business sense on both sides for a more highly developed feeder network to evolve. More deals will be originated by:
 - Fundless sponsors – including staff cycled out of larger groups who would have formed their own funds when barriers to entry were lower
 - A resurgent “merchant banking” sector – intermediaries who see selected opportunities to act as principals
 - SBICs and mezzanine funds that focus primarily on non-control investments and then pursue occasional buyout opportunities

”Consolidation” may be a misnomer. No doubt some firms will discontinue operations and others will merge into more successful entities. For most not in a position to continue, though, the end-game will be inability to raise a next fund, and that will play out over a period of years.

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