FINANCIER
WORLDWIDE corporatefinanceintelligence

PRIVATE EQUITY & VENTURE CAPITAL | BY IRWIN A KISHNER AND BROOKE E CRESCENTI

US private equity firms forced to re-evaluate strategies

If the fourth quarter of 2007 is any indication of what's in store for private equity firms in 2008, US private equity firms will not be the major players in the M&A market. Large buyout deals have fallen prey to the credit crunch. Private equity firms that had been riding high on cheap financing must now contend with lenders skittish to syndicate or lend on speculative deals. This coupled with high costs and increasingly burdensome covenants in the financing documents for deals that are approved, means there is a much lighter deal flow and increased likelihood that deals in progress will collapse during negotiations.

Lack of attractive credit should not sound a death knell for private equity investments. By some estimates, US private equity firms raised approximately $256bn in 2007 alone. Therefore, many firms presumably control enough capital in order to remain players in the M&A market. However, expensive credit coupled with the weak state of the US dollar, means US private equity buyers face a new hurdle – foreign investors, particularly European, Asian and Middle Eastern, with strong currencies, snapping up attractive 'bargains' in the US. In fact, foreign investments comprised nearly half of US purchases in the fourth quarter of 2007, including two transactions - the takeover of Commerce Bancorp Inc by Canada's Toronto-Dominion Bank and the acquisition of Navteq Corp by Finland's Nokia Oyj - valued at over $8bn each. A large portion of foreign investment can be attributed to sovereign wealth funds. Such investment minded funds are attractive to US targets because of their typically long term strategies and hands off approach to day to day operations following an investment. The reserves in these funds can run into the billions and trillions of dollars, especially in oil producing counties, making bargain shopping in the US an attractive way to invest some of that capital.

Large foreign private equity firms are also increasing their presence in the US, particularly in New York. This allows the firms to be closer to the deals and effectively increase the competition in the US private equity market. The increased presence of foreign private equity firms in the US is reminiscent of the influx of US private equity firms in Europe several years ago – the difference being that US firms helped create a successful buyout market in Europe, while foreign firms coming to the US have the benefit of taking advantage of the weak US dollar in an already thriving M&A landscape. These foreign firms are investing in a wide range of industries, from luxury retail brands and financial institutions to technology companies and real estate. Although the increased foreign presence may be good for the US economy generally, by keeping deals moving, US private equity firms have been, and will likely continue to be, feeling the pinch. The increased competition combined with an already tenuous domestic credit situation means that US private equity firms may have to re-evaluate their investment strategies for the coming year.

Deals completed in this down market for US private equity may actually produce higher returns in the long run, if firms are smart in their investments. Instead of seeking out the mega deal as many firms did in the early part of 2007, private equity investors may consider foregoing purely financial deals in favour of focusing on strategic investments – investments in companies likely to thrive post investment. Private equity firms that contribute management, intellectual and operational resources to target companies in addition to purely capital based investments may have to commit to more hands on, longer term investments than they typically would. In today's M&A world, adaptation is key to firms looking to regain strong positions as players in the M&A market.

Another solution could be increased utilisation of the group bid. Despite today's hurdles in securing major financing, combined private equity firm efforts could alleviate the pressure on each firm individually, allowing for firms to participate in the mega deals they have been accustomed to. As a practical matter, for those firms willing to continue to pursue large acquisitions, they would be smart to protect their interests early on in the negotiation process in the event that deals collapse – not an uncommon occurrence in the fourth quarter of 2007, and a risk that is likely to persist in the current lending market. Target companies have historically been faced with breakup fees in the event that they terminate M&A deals still in progress. However, targets are increasingly negotiating 'reverse' breakup fees into their deals, requiring potential buyers to pay up if they walk away from the table first. Although these fees may be negotiated as seemingly small percentages, such as 2 to 4 percent of the deal's overall value, in larger deals, this could mean a payout of hundreds of millions of dollars with no investment to show for it. As more target companies become savvy to the insurance potential of these reverse breakup fees, it would behove private equity investors to take on deals with a high probability of successful completion, in order to save both time and potentially significant capital.

The future of US private equity firms in 2008 is somewhat unpredictable. Firms could enjoy a generally stable and successful year fuelled primarily by mid-market buyout transactions or strategic financial investments by private equity firms. On the other hand, firms could suffer a dismal year, due to an inability to compete with foreign investors or strategic M&A initiated by US companies and the continued credit crunch. If these firms can find creative ways to utilise the large amounts of capital they have amassed and the Federal Reserve keeps short term interest rates low, US private equity firm deal flow should rebound sooner rather than later. ■

Irwin A Kishner is a partner and Brooke E Crescenti is an associate, at Herrick, Feinstein LLP.
Mr Kishner can be contacted on +1 (212) 592 1435 or by email: ikishner@herrick.com
Ms Crescenti can be contacted on +1 (212) 592 5937 or by email: bcrescenti@herrick.com