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Lending Crisis Rocks Middle Market Buyouts

This is an unsettling period for private equity. The constriction of credit following the collapse of Lehman Brothers precipitated a sharp decline in deal volume within the middle-market. Now desks suddenly appear less cluttered than they did a few months ago.

So for those deals that are getting done, what does the lending market look like? Well, that depends. For larger deals, most all of the traditional sources of debt capital disappeared with the breakdown of the syndication market for senior debt. Within the middle-market, some of the traditional players are still "open for business." However, the terms for new deals after the Lehman collapse reflect a severe reluctance to take risk by senior lenders.

Larger spreads

The October issue of Buyouts Magazine reported that the average spread for investment-grade senior loans had increased from 225 basis points to 625 basis points above Libor. Our review of commitment letters for lower middle-market deals (senior facilities under \$100 million) issued since the Lehman Brothers collapse indicates that spreads range anywhere from 525 to 800 basis points above Libor. Many of these loans have a Libor floor of around 300 basis points. The wide range in rates reflects both the weakness in the senior debt market and the variability of these particular credits.

Lower leverage ratios

Recent term sheets reflect a reduced appetite for leverage. Buyouts Magazine reported senior leverage in mid-market deals had fallen from 4.7x to 2.9x. from Q2 2007 to Q2 2008. From the commitment letters we have reviewed for middle market deals, that number appears more like 2.5x in Q3.

Larger equity checks

The lower leverage has caused private equity sponsors to write larger equity checks. This trend will continue until sellers agree to accept lower sales price multiples or the lending markets become more robust. Equity checks, which include management re-investments, are approaching 50% of the purchase price in many transactions.

Sub-debt resurgence

Subordinated debt lenders have stepped up to help fill the void created by the lack of senior lending. Sources of mezzanine funding are stable and less reliant on the syndication market. However, interest rates (historically in the range of 13% to 17%), seem to be inching higher. Non-call options, which prevent companies from repaying debt within a set period of time, have become standard and in some cases lenders are also asking for warrants.

Although these are challenging conditions, most private equity sponsors are still positive on the opportunities and have healthy amounts of capital to invest at the present time. It will take some time for lenders to return to the market with renewed confidence. The \$250 billion infusion from the Treasury to purchase preferred stock of qualified financial institutions will help, but not overnight.

About Paul Hastings

With 18 offices throughout Asia, Europe and the United States, Paul Hastings has the global reach and extensive capabilities to provide personalized service wherever our clients' needs take us. Through a collaborative approach, entrepreneurial spirit, and firm commitment to client service, the professionals of Paul Hastings deliver innovative solutions to many of the world's top financial institutions and Fortune 500 companies.

For more information about Paul Hastings, please visit www.PaulHastings.com.