Still bobbing along

Executive summary

- Jim Keeling gives a practitioner's view of trends in the number, value and financing structures of management buy-out deals, and concludes that all is perhaps well and, in some respects, surprisingly buoyant.

JIM KEELING LOOKS AT THE FIRST HALF OF 2008 AND FINDS SURPRISINGLY BUOYANT RESULTS IN MANAGEMENT BUY-OUT ACTIVITY.

The year started with a very confusing picture, caused by two diametrically opposite effects. The slowdown in the economy led to nervousness and therefore less deal-making, and at exactly the same time fiscal changes in capital gains tax rates and non-domicile rules created a huge incentive for owners to sell their businesses. A few months ago, we were very unsure how things were going to turn out as the year progressed.

Well, the statistics, and indeed the experience for us in the first half, made us heave a big sigh of relief. All seems to be well – at least for the moment and at least in some, or maybe most, parts of the market. Let's have a look at the facts as illustrated by the preliminary second quarter 2008 statistics.

First, even in larger buy-outs (>€150m) – the part of the market you might have thought would have been completely destroyed by the credit crunch – all is not as much doom and gloom as you would have expected. Yes, total deal values are down compared with 2007 – but that was a mega year. Compared with earlier years, 2008 is doing fine by value at €13bn in the year to date; it's similar to 2006 and better than the same point in the year between 2002 and 2005.

The pattern is the same in terms of numbers of deals (24 for the year to date), but the difference compared with 2007 is noticeably less marked. It looks like we have lost just a few of the really mega-mega buy-outs, which is a problem for the small community of deal-makers in that sector – one was heard to comment, "What's the point of coming in to work when there is nothing to do?" – but not necessarily for the rest of the private equity community.

Smaller buy-outs (<€150m) appear to be doing just fine, with numbers of deals at 82 compared with 88 at the same time last year and aggregate values also only slightly down at €2.8bn, compared with €3.9bn at the same time in 2007 and €2.9bn a year earlier.

The news for early-stage and expansion capital deals is also not nearly as bad as it was for example in the gloom-ridden days of 2003 to 2005. At 133, the number of deals is higher than in any of those three years and aggregate values at €1.7bn are higher than both 2003 and 2005, although not up to 2004 levels.

So perhaps part of the reason for gloom – to the extent that it can be located – is in reality that 2007 was a truly exceptional year, even by the standards of the ever-growing European private equity markets.

But despite the statistical evidence we cannot help but feel a little nervous about the future. It is certainly true that banks have, across the board, reined in the amount they will lend, albeit the impact is much more obvious for larger deals. One mid-market equity house told us recently that they had seen a marked downturn in the number of prospective deals coming through their doors, but in the same breath they admitted to such a flurry of new investment completions that they were setting their sights on raising their next fund early!

The contradictory evidence does not stop there. The enterprise value to EBITDA (earnings before interest, tax, depreciation and amortisation) multiples for private equity-backed deals done are ahead of the corresponding multiples for the FTSE All-Share. While this might be interpreted as an indicator of buoyancy in the market, the outlook in the survey of future expectations is almost universally negative.

So the messages are mixed. One possible explanation is that a lot of transactions happened in the first five days of quarter two – and they did – before tax changes came into effect. We will have to wait till later in the year to get a real view as to whether the sector has slowed down.

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This article is an edited extract of Corbett Keeling's regular quarterly commentary on private equity activity in the UK, and was originally published in Unquote, the magazine of the private equity industry.

Figure 1: Predicted activity levels in the next year in the mid-market buy-out segment (<€150m)

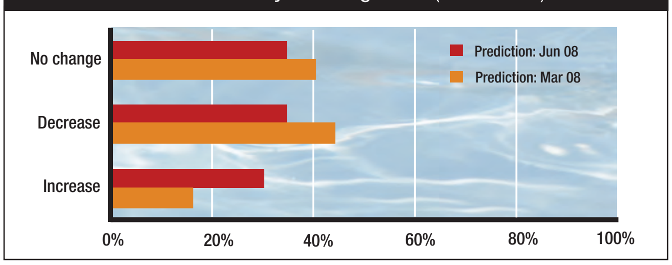


Figure 2: In the next year, what will happen to gearing in UK buy-outs?

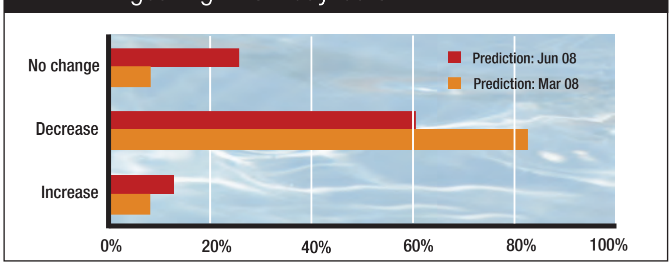
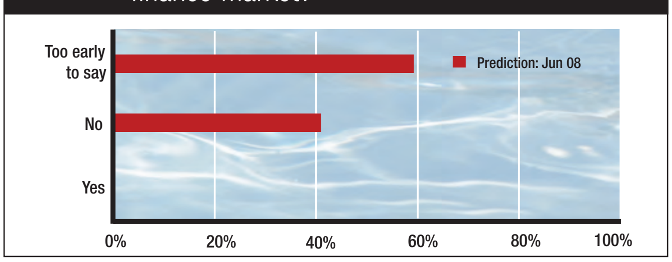


Figure 3: Is confidence growing in leveraged finance market?



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