The Deal Pipeline

[RETURN TO ARTICLE]

Private equity

Share Reprint Save to My Articles

Still not buying in to a buyout boom

By **Taina Rosa** Updated 12:21 PM, Jan-11-2013 ET

Private equity firms rushed to get deals done in late 2012, partly to beat an expected increase in taxes on gains made from investments. As a result, **private equity**-backed buyout dealflow in North America reached a post-Lehman high of 1,590 deals valued at $152.3 billion, according to market intelligence firm Preqin. While the lingering uncertainty in the U.S. economy is largely expected to make private equity investors cautious in 2013, the first week of the year saw plenty of activity.

After much back and forth, at the start of the new year Congress finally announced that the capital gains tax will go from the current 15% to around 23.6%, in line with the level expected by many private equity industry insiders.

The public equity markets seemed to take the news well, with the Dow surging 308.57 points, or 2.35%, and closing at 13,412.55 on Jan. 2.

"The market reacted positively [to the fiscal cliff measures] because it had already priced in either no deal or a bad deal being done, but there is still a lot of uncertainty," said Steve Karol, founder and managing partner of **Watermill Group**.

A California-based private equity manager who did not want to be named predicted that a spillover effect would take place in early 2013 despite the uncertainty, meaning that transactions that did not close before the end of 2012 will still get done this year despite the increase in capital gains taxes. Others in the industry expect activity to level off — in part because so many transactions were squeezed into the final months of 2012. And continued political uncertainty will also likely hold down volume. In short, while cheap debt will keep the pipeline flowing in 2013, another boom is likely a year or two off.

Daniel Rosenberg, managing director at **Sterling Partners**, predicted a spillover effect into early 2013, especially since the increase in capital gains tax was not drastic. "A number of businesses that didn't sell by the end of 2012 are still actively seeking to do so. That is an indication that while they would have preferred to have a lower tax rate, [the increase] was not the sole driver behind their intentions to sell," he said.

He should know. Within the first 10 days of January, Sterling Partners announced three transactions. On Jan. 8, the firm said it acquired **Spartan College of Aeronautics and Technology**, an aviation-maintenance school for training pilots, aviation technicians and nondestructive testing professionals, for an undisclosed amount.

Also on Jan. 8, Sterling said it sold **Pacific Interpreters Inc.**, a healthcare-focused provider of interpretation and translation services, to **Abry Partners LLC**-backed **Language Line Services Inc.** It did not reveal the terms of the transaction.

The next day, Sterling said it acquired **PlattForm Advertising**, a leading provider of comprehensive marketing and enrollment-management services to colleges and universities, from **Arlington Capital Partners**. Financial details of the transaction were not disclosed.

Riverside Co. also announced several deals just as the new year was taking off. On Jan. 6, the firm said it invested an undisclosed amount in gift card reward program facilitator **GiveAnything.com Inc.**, which does business as CorporateRewards.

The same day, Riverside said it invested in Australian game and simulation system developer **Bohemia Interactive Simulations** s.r.o.

On Jan. 8, the private equity firm said portfolio company **Emergency Communications Network LLC** acquired **Jacosoft LLC**, a software developer doing business as DeltAlert, for an undisclosed amount.

Despite an active first week of January, Rosenberg did note, however, that dealflow could slow down somewhat this year due to the amount of deals that closed before the end of the year.

The California-based private equity manager also expects private equity firms to be cautious this year as they consider the possibilities of a double-dip recession.

"Taxes for all Americans did go up and very little was done to address the deficit," said John Schumacher, chairman and founder of **GoldPoint Partners** LLC, the investment boutique of **New York Life Insurance Co.** formerly known as **New York Life Capital Partners**. "Now we have a new fiscal cliff looming, probably for March," he said.

Moody's Investors Service said in a Jan. 2 note that the fiscal package passed by both houses of Congress is "a further step in clarifying the medium-term deficit and debt trajectory of the federal government." The ratings agency said that the package does not, however, provide a basis for a meaningful improvement in the government's debt ratios over the medium term. A lack of further deficit reduction measures could affect U.S.'s AAA rating negatively, Moody's warned.

Karol believes it will be the economic uncertainty, and not necessarily the increase in capital gains tax, that will prove detrimental to dealmaking this year. "Uncertainty is what causes markets to be skittish," he said. "I don't think this will stimulate dealmaking. I don't think we will see a change in behavior until the U.S. has a clear path for its financial future," he added.

"With the uncertainty in Washington, the slowdown in Europe, and China slowing down a little bit, we believe that U.S. growth in 2013 will be flat. Some think we might even have a recession or maybe 1% growth. I think everybody is going to be a little cautious in case things get worse," Carl Thoma, managing partner of **Thoma Bravo LLC**, said.

Also, because private equity firms rushed to get deals done before the end of the year, many could wait on the sidelines early in 2013. "A lot of deals were done last year, so the pressure is off right now," Karol said.

The bright side for private equity firms is that economic uncertainty also brings opportunities. After all, 2012 also started off with turbulent market conditions and still posted a post-2008 high.

"We are now seeing opportunities where purchase multiples have come down because of the uncertainty," Schumacher said.

The California-based source agreed, saying that he expects purchase multiples for transactions in sectors that are affected by economic downturns, such as the consumer/retail sector, to be flat or to decrease this year. On the other hand, he added, sectors deemed recession-proof, such as energy and technology, could fare better.

Rosenberg, meanwhile, said that cheap debt, coupled with a tremendous amount of dry powder, could actually drive multiples up, especially for healthy targets.

The buy side may be the most active dealmakers as firms with available dry powder put their money to work. For example, GoldPoint, which saw its dealflow increase more than 30% in 2012, had already made commitments to one co-investment transaction and one mezzanine transaction in the first week of 2013, according to Schumacher.

GoldPoint makes commitments to private equity firms, co-invests with its general partners and also provides mezzanine financing. The firm raised $980 million for its NYLCAP Mezzanine Partners III LP fund in April.

Another good sign is that industry sources expect a prolonged period of low interest rates, which could help keep dealflow alive.

"I think the **Federal** Reserve is probably going to keep interest rates low for quite a while, so the second half of 2013 and 2014 could be pretty attractive times," Thoma said.

Debt financing should also be available. Leonard M. Tannenbaum, CEO of business development company **Fifth Street Finance Corp.**, said that while equity used in buyouts stands at around 40% to 45% now compared to about 30% in 2007, demand for debt is brisk because pricing is lower.

"We are able to borrow cheaper, so we are able to lend cheaper to our clients. At the same time, the spreads between the amount at which we borrow and lend are about the same," he explained, adding that borrowing costs for his BDC are about 50 to 100 basis points cheaper than a year ago, partly due to Fifth Street getting investment grade ratings. **Standard & Poor's** and Fitch Ratings assigned the company a BBB- rating in early 2012.

The more aggressive nature of BDCs and other alternative lenders vis-á-vis the heavily regulated commercial banks could drive higher debt multiples in larger deals, Rosenberg said, although he does not believe debt-to-equity ratios will go to levels seen before 2008.

Despite the overall economic uncertainty, many sources did agree that the longer-term outlook for the U.S. economy presents a sunnier picture.

Schumacher, for instance, is decidedly bullish on the U.S. economy. "We have had five consecutive months of improvement in the housing market, and we see early signs of a manufacturing renaissance, driven by America's world-leading productivity and energy prices," he said. "America is now the fastest-growing oil producer, and if this trend continues we could be a larger producer than Saudi Arabia by the end of the decade."

"The U.S. is enjoying compelling manufacturing cost advantages, and by 2015 we expect the Sunbelt to be one of the most competitive manufacturing regions in the world. We're already seeing some of our portfolio companies reshoring manufacturing and service jobs back into the U.S.," Schumacher added.

Share **Reprint** **Save to My Articles**