Where’s the Deal Flow? (Last of a Series)

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The question surrounding the leverage loan pipeline involves many factors. We’ve discussed some of them, including regulatory bank hurdles, uncertainty surrounding the economy, and hesitation by private equity sponsors to pay high multiples.

Several readers weighed in with their own perspectives on the slowdown. “First quarter always has some degree of seasonality,” the CEO of one middle market finance shop told us. “Particularly with so much worry about energy and interest rates, there’s just nothing compelling buyers right now.”

Another senior banker agreed. “In previous years there’s always been some external factor driving M&A activity, whether it’s tax-motivated or political. Today there’s such a cloud over everything, it’s hard to feel a sense of urgency about deal-making.”

High purchase price multiples, of course, haven’t stopped sponsors from unloading (as one mega fund founder memorably put it) “everything that isn’t nailed down.” (See our *Chart of the Week*). An anecdotal survey of top middle market PE firms points to the ratio of selling to buying has skewed towards selling for the past couple years.

But that hasn’t always translated to more deal flow. For one thing, strategic investors are flush with cash. They make formidable competitors in auctions since cheap financing is readily available, particularly for larger corporate buyers.

Also, secondary (sponsor-to-sponsor) buyouts don’t always translate to new financing opportunities. If the borrower has performed, especially through the downturn, existing lenders will likely roll with new ownership. That leaves less room for new entrants.

One exception is when banks represent a majority of the existing group. Increasingly, those banks take the opportunity to bow to regulatory pressure and exit leveraged loans. Non-banks are eager to fill that vacuum, often with equally flexible terms.

Looking ahead, there’s reason for optimism regarding deal supply. PitchBook reports (Link: http://theleadleft.com/the-pulse-of-private-equity-1252016/) that almost one-third of the almost eight thousand portfolio companies held by PE firms were bought seven or more years ago. The credit crisis delayed the sale of some of these holdings. As the economy strengthens, more sponsors will try to realize on these investments.

Also, Thomson Reuters estimates that over $580 billion of middle market loans associated with those old buyouts will be up for refinancing over the next four years; over $100 billion this year alone. And plenty of banks who originated those loans are either less active or completely out of the business.

Finally, one long-time follower of the capital markets says another element may come into play. ”When the Dow hits 18,000 it gives a real psychological boost to markets,” he told us. “People see the bullish headlines and moods can swing from doom to boom very quickly.”