Triple whammy

The '90s torrent of private equity/venture capital fund formations has morphed into a trickle, though long-term prospects offer hope

by Jack S. Levin

The economic bubble of the late 90's and the resulting crash have thrust myriad complex issues on the private equity/venture capital industry and its lawyers. Because the bubble was so much steeper on the upside than in other recent booms, the resulting downward spiral has been far more drastic and sustained.

During the bubble, PE/VC professionals formed funds at record rates and in record amounts, straining the capacity of law firms with expertise in the fund formation area. Because of the funds' fantastic performance, relatively new groups were able to raise large sums, and groups with long-strong records were able to form multibillion-dollar megafunds. To stay abreast of the frantic deal flow, large funds staffed up, hiring substantially more professionals as the bubble percolated.

The crash has put a triple whammy on the pace of fund formations:

• It has dampened investors' enthusiasm about committing fresh capital.

• The flow of attractive deals has atrophied, leaving most PE/VC funds with far more cash than they can now comfortably invest and obviating the need for even a fund with a long-strong record to raise a new fund.

• PE/VC funds have been forced to shift focus from seeking new deals to the unpleasant task of restructuring portfolio companies and reducing management company expenses (e.g., many now-unnecessary professionals).

Hence the fund formation torrent of the late '90s has slowed to a trickle. But over the next several years, as legacy megafunds invest excess cash, as their preoccupation with restructuring a large inventory of overleveraged portfolio companies fades and as the economy brightens, we will again see robust formation activity.

Three factors have hindered the pace of private-equity LBO and leveraged-recapitalization activity: unrealistic seller expectations, PE professionals' reluctance to pull the trigger on new acquisitions and a dearth of traditional debt financing from banks, high-yield bonds and mezzanine funds.

Most sellers still fondly recall the stock market's recent exuberance and the resulting inflated prices for private LBOs and leveraged recaps. Hence sellers as a group continue to seek prices for their businesses that have become unrealistic in the current economy.

In today's cautious world, PE funds concentrate on proven businesses with positive cash flow and a strong likelihood of significant future expansion. Even then, they take their time to close as they subject targets to due diligence, sometimes many times over.

Debt financing, which provides the leverage for an LBO or leveraged recap, continues in short supply because of massive bank consolidations; bank and regulator timidity in the face of an uncertain economic picture; and the wariness, and in some cases actual absence, of high-yield bond buyers.

History indicates seller pricing will become increasingly more realistic as sellers slowly absorb the message that it is indeed a new economy—and not the recessionless new economy they expected 36 months ago—with business values substantially below their level at the beginning of the 21st century.

Debt financing will again become more available as the economy brightens, and the surviving PE funds will again find irresistible bargains among the growing stock of businesses available for acquisition. The pace of LBO/recap activity will then increase dramatically—especially in light of the huge overhang of money in PE funds' pockets, ready to be spent on reasonably priced acquisitions.

Indeed, even as debt financing from traditional sources continues in short supply, the ever-resourceful PE community is finding creative ways to bridge the gap—seller paper, earnouts, PE-fund bridge loans, expanded PE-fund-sponsored mezz funds and, of course, more equity and less debt to finance an acquisition where all else fails.

Startups and high-tech growth equity deals closed at a pace beyond torrid during the bubble. Today, virtually every VC professional is afraid to invest new money in a startup or high-tech company that is not yet cash-flow positive and self-sustaining; they fear that when the money from this round runs out, no one will be willing to do the next round.

During the bubble, by contrast, a nearly endless list of VC funds stood ready to supply a cash-flow-negative company with yet one more alphabet round, secure in the knowledge that countless other VC pros would be ready to do subsequent alphabet rounds at ever-escalating prices while the company remained cash-flow negative.

The alphabet merry-go-round has been replaced by the specter of a grim game of musical chairs; the fear is that today's VC investor would be left standing in the cold as soon as its money has been spent, with no other VC investor willing to invest.

Jack S. Levin is a senior partner at Kirkland & Ellis whose practice concentrates on complex business transactions, including M&A, private equity and venture capital. He is the author of a widely used text on the subject and the co-author of another. This article is the first of two parts. Part two will appear tomorrow.

JANUARY 30, 2003 THURSDAY PP.07

AS FEATURED IN ... The Daily Deal

Down not out

The bright days of private equity and venture capital financing seem gone forever. But wait for the inevitable economic rebound

by Jack S. Levin

Although private equity start-ups and high-tech growth equity deals are virtually invisible at present, the current circumstances are not permanent. It is just that badly burned venture capital funds are trying to catch their collective breath.

However, because of the immense carnage that many of their deals produced at the end of the bubble of the late '90s (see the first part of this article, The Daily Deal, Page 7, Jan. 30), investors and venture capital funds will likely continue to view such start-ups and deals with extreme skepticism—and hence they are likely to be the last type of PE/VC transactions that will return in substantial volume.

Despite everything, PE/VC funds and their lawyers have kept themselves busy in this postbubble world. There is no deal more complex and time-consuming than the workout/restructuring/bankruptcy of an overleveraged portfolio company, and the number of these in process is phenomenal.

In the wariness prevailing in the business world today, capable PE/VC professionals and their counsel still spend substantial time looking at deals. Although public investor confidence evaporated after the public stock market's precipitous crash, compounded by the accounting scandals that followed, PE/VC professionals by contrast remain confident (although cautious) of their ability to find desirable deals and perform adequate due diligence.

In the golden days of precrash euphoria, 80% of deals closed, often within eight to 12 weeks; in today's cold, cruel world, a far lower percentage of deals close, and they often take four to eight months.

Thus, even though fewer transactions actually reach closure today, PE/VC professionals and their lawyers devote substantial time and attention analyzing numerous potential deals—and they spend far more time on those that close than they did in the go-go days. This keeps them not only busy but relatively happy.

Another factor in today's scene is that many creative PE investors have converted themselves, at least part-time, into turnaround experts. They are investing PE money in the large crop of workout/restructuring/bankruptcy transactions, seeking to capture good—but badly overleveraged—businesses now being delevered both in and out of bankruptcy (including Sec. 363 bankruptcy sales).

All in all, the golden age of PE/VC may seem forever behind us. But since PE/VC financing first became popular in the United States in the early 1980s, PE/VC has been a cyclical industry rising and falling with the public stock market, with some upturns more robust than others and some downturns more severe. The current downturn certainly falls into the "most severe" category.

However, when the economy begins its inevitable rebound, PE/VC financing will again provide a solid expansionary base. Relatively unknown 20 years ago, PE/VC financing now constitutes an integral part of the American economy—like the other invention of the 1980s expansion, high-yield (junk) bonds.

Can PE/VC financing rebound with the initial public offering window as firmly closed as it is today? The best PE/VC investments are very often made while the IPO window is closed, when investor confidence is low and good businesses are available at bargain prices. Such investments then have time to reach maturity before investor confidence returns and another IPO window is opened.

Thus, many desirable PE/VC investments are likely to be made in the near future and sold once the economy turns up, buoying investor confidence and recharging IPO activity.

There's something else to be factored into the equation, however. In the author's 40 years of practicing law in the United States, the tax, Securities and Exchange Commission and other regulatory complexities have grown exponentially. The voluminous Sarbanes-Oxley Act that was passed and signed this year adds yet another set of often salutary—but nevertheless complex—hurdles to effectuating U.S. business transactions and conducting U.S. business operations.

For example, the new regulations prohibit loans by public or quasi-public companies to executive officers and directors, increase reporting obligations (and the penalties for misreporting) and create complex new governance rules.

Nevertheless, while doing PE/VC transactions will remain complex (and probably become even more complex), the American economy is likely to turn smartly up in the relatively near future—and with it private equity and venture capital transactions and the rewards they bring.

Jack S. Levin is a senior partner at Kirkland & Ellis whose practice concentrates on complex business transactions, including M&A, buyouts, private equity and venture capital investing. He is the author of a widely used text on these subjects, and the co-author of another, both issued by Aspen/Panel Publishers. This article is the second of two parts. Part one appeared yesterday.

AS FEATURED IN ... The Daily Deal