HOUSTON
BUSINESS JOURNAL
Strictly Houston. Strictly Business.

Week of October 10-16, 2008

Is financing possible in the face of the collapse of the capital markets?

BUILDING BUSINESS

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Growing companies seeking to raise capital face the most challenging times in years following the collapse of Wall Street.

What does all of this mean to middle-market companies that depend on capital inflow to finance operations, organic growth and acquisitions?

It's important to try to understand and explore the opportunities and challenges facing companies today in private equity, mergers and acquisitions, venture capital, commercial real estate finance and commercial finance.

PRIVATE EQUITY

Private equity funds continue to have substantial uncommitted capital for attractive investment opportunities. The estimates of this liquidity range from $240 billion to $300 billion, and it could take years to run off. With the limited availability of debt and lower valuation multiples, there is pressure on companies seeking private equity to finance growth.

Less debt availability as a percentage of transaction value necessitates a lower enterprise value if the equity provider is going to achieve its threshold returns. On the other hand, if more equity is required at lower valuations, the sponsor is diluted and change of control can become an issue. Nonetheless, even with lower valuations and lower liquidity ratios, there is, and will continue to be, private equity available for the right situations.

MERGERS AND ACQUISITIONS

The M&A business continues to be active in the middle market, but the dynamics are changing. The same issues that affect private equity transactions also impact M&A — valuation multiples and leverage availability and ratios. There is pressure on valuation multiples. Also, credit standards are tightening. As a result, less debt is available to finance transactions, requiring more equity, which often means sellers have to provide a layer of seller financing.

A positive impact of the crisis is that the difficulty private equity investors are having underwriting investments and achieving targeted returns means strategic buyers are becoming more competitive. This is good news for sellers and brings more potential buyers into play.

VENTURE CAPITAL

The most significant impacts of the credit crisis on access to venture capital are the virtual shutdown of the IPO market in 2008 and the significant reduction in M&A transaction volume. The time periods for exits for early stage investors are extending by up to four years. This is putting pressure on investment returns, which will, from an underwriting perspective, drive down pre-money valuations. Nevertheless, there is substantial capital still available for venture deals for the right company doing business in the right area and having a reasonable expectation level in terms of valuation, deal structure and pricing.

COMMERCIAL REAL ESTATE FINANCE

Now for the bad news. Companies involved in commercial real estate are facing an extremely limited financing market.

Even with good core fundamentals, there is little liquidity in the market.

According to a recent CBRE study, conduits provided more than 50 percent of all real estate financing in the first half of 2007, compared to 3 percent in the first half of 2008. That precipitous drop in liquidity has not been replaced. This is creating a stagnant state, with transaction volume at extremely low levels. Without transaction volume, the good news is that values are not noticeably declining. The bad news is that the stagnation might be the only thing holding values. Once liquidity returns to the market, there could be downward pressure on valuation. The key is quality, as lenders and buyers flee to quality product, location and people.

Another significant factor is interest rates. Even if financing can be obtained, and even with low treasury rates, interest rate spreads have become extremely volatile, resulting in higher overall interest costs. This drives down leverage and requires that sponsors invest more equity. This drives down returns, which drives down values, which increases equity requirements, which drives down values.

Get the picture?

COMMERCIAL BANKING

Large commercial banks are in crisis and essentially shut out of the lending market. Large exposures to residential mortgages, land and residential housing construction have crippled many institutions. There will continue to be tremendous pressure on the banking industry. While writing this month's column, the federal government's controversial bailout program was mired in political limbo. We can anticipate many more bank failures and very tight credit for the foreseeable future.

That being said, there are many healthy regional banks that have avoided the subprime debacle and have sufficient capital to continue to do business. These banks are likely to attract fresh capital to take advantage of opportunities to grow by acquiring assets of failing competitors. With increased capital comes increased lending ability. Quality companies with assets, revenue, cash flow and management, will have access to bank financing from these well-positioned banks.

So what's the lesson?

Good middle-market companies that are not financing real estate can still access private equity or venture capital and, in some cases, commercial bank financing. The real estate markets are essentially shut down and large commercial transactions that require large credit facilities from money center banks are at risk.

Research the options and be thoughtful and patient in pursuing alternatives.

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