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Dry Powder Could Fire PE Past Dampers In 2012

By **Samuel Howard**

Law360, New York (January 01, 2012, 12:00 AM ET) -- This an extraordinarily uncertain year for private equity, but the sheer abundance of dry powder and looming fund deadlines could fuel a resilient deal market in spite of fitful times, attorneys told Law360.

While 2011 faltered, disappointing expectations for a banner year in the private equity space, 2012 holds opportunities for firms that are opportunistic enough or eager enough to put dry powder to work before it's too late, attorneys said.

But there are daunting challenges as well. From the instability of the eurozone, to the sputtering economy, the domestic debt crisis and the pervasive ambiguity of an election year, 2012 already looks an ominous place to do business.

The pull of the deal, however, might overwhelm the massed uncertainties and brush aside concerns about steep buyout prices or jumpy credit markets, fortifying the private equity field. Especially given private equity's store of unspent capital, or dry powder, and the imperative to get long-dormant money working, attorneys said.

"From an economic standpoint, 2012 is a mystery but the European and American debt issues are ominous," said Christopher Hagan of Brown Rudnick LLP. "Nobody is expecting a boom. But on the other hand, there's a lot of dry powder and private equity firms are actively scouting for deals."

Hardwired for the deal, private equity firms always wrestle with whether to spend or return investor money, but this year, the dilemma is unusually intense. 2012 falls in the midst of a boom-bust cycle of historic scale, leaving firms packed with cash but short on time, according to Edward Nelson of Gibson Dunn & Crutcher LLP.

“While there is always dry powder, 2012 is qualitatively different in terms of the sheer amount that is nearing its investment horizon,” Nelson said. “Massive sums were raised between 2006 and 2008, followed by a spell of no deal activity. So there may be a strong motivation to put the stockpiled money to work.”

Stir crazy and flush with cash, the firms may also be hell-bent on making deals because fundraising all but flat-lined after 2008, leaving them with scant firepower once those vintage funds expire, Gabor Garai of Foley & Lardner LLP said.

And if the Obama administration frees up the credit market to give the economy an election-year shot in the arm, the idle money and investment imperatives could make for a hot market, Garai said.

If 2011 trends stay true this year, the deal market will be characterized by a handful of hotly contested auctions, where the winner risks overpaying. The abundance of dry powder combined with the relative paucity of attractive assets makes for high prices, according to Oliver Brahmst of White & Case LLP.

Private equity could also experience an uptick in business that accompanies hard times. Distressed assets will surface if the markets continue to sour and private equity will also see more recapitalizations as companies will want to refinance credit facilities through equity investment and new more attractive debt financing, Hagan said.

This year will also see greater private equity investment overseas as firms continue to explore emerging markets, where there are more middle-market targets and less need for highly leveraged transactions, Brahmst said.

Targets in emerging markets are particularly attractive because private equity investors can produce worthwhile yield through operational improvements without taking on massive debt, Brahmst said.

There also remains some cautious optimism given private equity’s resourcefulness and the resilience of certain industries, like the energy, health care and business services industries, attorneys said.

On the fund formation side, this year could see a deepening bifurcation in the market between large well-established firms, which will continue to attract investors in 2012, and newer managers that face an uphill battle, Nelson said.

But there are enough worries to dampen even cautious optimism. While kegs of dry powder and pent-up desires enhance the deal climate, they alone cannot create a robust market. For that, you need ready sellers and ebullient lenders. If either are lacking, it could be a thin marketplace — anything but a dealmaker’s playground, Brahmst said.

“Private equity funds have been sitting on dry powder for years yet the deal market has not gotten back to where it was before the crash,” Brahmst said. “Sellers remain reluctant to put assets to market when they are coming off a recession and the sale price could be depressed.”

Even though select sales have fetched elevated prices, there is little reason to think private equity will continue to pay inflated premiums across the board in 2012, Hagan said. If more assets come up for sale, buyers will be less fervent, especially if the credit markets tighten up, and sure to disappoint sellers.

That gulf could be exacerbated by tightened credit. Under current circumstances, it's hard for anyone but the leading private equity firms to gain financing and the sovereign debt crisis in Europe threatens a second credit crunch that could severely hamper private equity activity, said David Sands of Sheppard Mullin LLP.

"Most banks appear willing to put out a lot of money for very strong credits. That may mean those deals involving solid companies that have access to the institutional loan market will demand a significantly greater private equity interest," Sands said. "It will be interesting to see which funds will bow out of the current market rather than pay the premium or be forced to write 100 percent equity checks."

Some private equity funds kindled deals in the wake of the recession by skirting the credit markets and pursuing equity-check acquisitions, with a view to refinancing once the market improved. If current conditions continue and banks retreat, Sands said, the equity-check play will not be an option and buyers will be even less likely to stick their necks out.

All this means that junior private equity firms could get pummeled as investors and banks grow conservative. Even the silverback firms are having to work harder and longer to drum up new investors in a jumpy market. Many are relying on existing investors that are reupping but reducing their exposure, and without a stream of new investment, firms will struggle to do more than keep pace, Nelson said.

"Institutional investors have been sitting on enormous amounts of money but remain reluctant to put it to work. If anything, they are playing it safe and going with the biggest firms," Nelson said. "No pension manager is ever going to lose their job giving $50 million to a Blackstone."

--Editing by John Quinn.