Deal Market Braces for Credit Crunch

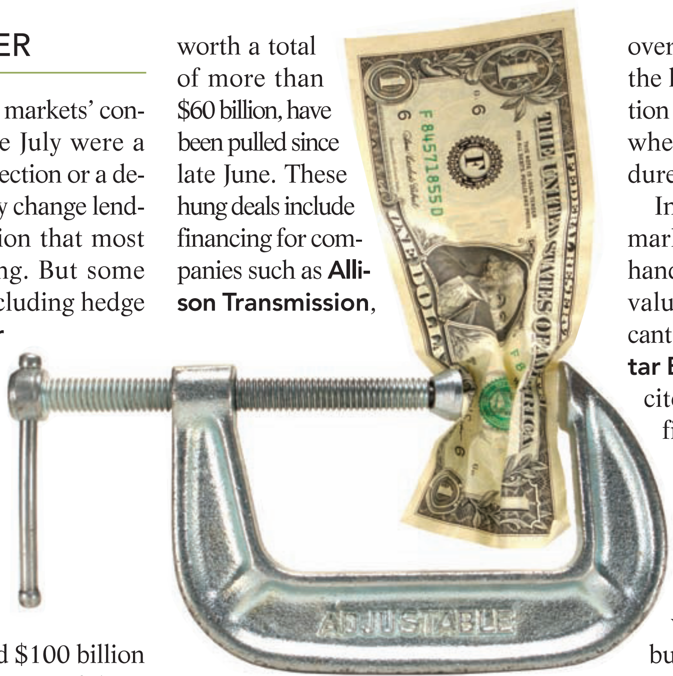
The lender pullback is having a greater impact on the large market, according to dealmakers, though many are viewing the squeeze as a permanent change in conditions

BY BRENT SHEARER

Whether the debt markets' contortions in late July were a temporary correction or a debacle that will permanently change lending conditions is a question that most dealmakers are pondering. But some fear that the evidence, including hedge fund meltdowns at **Bear Stearns** and **Sowood Capital**, might point to the latter scenario.

According to **Citigroup** research, the US deal pipeline sat at around $300 billion as of the end of July, with roughly $200 billion of that representing bank loans and around $100 billion representing high yield. "Some of these deals will be restructured and sold, some will be postponed, and some will end up on bank balance sheets," Citi analyst **Keith Horowitz** says in a research note.

But while it sounds simple, dealmakers are already feeling the squeeze, as both the leveraged loan and high-yield markets are "suffering from a 'buyer' strike" in the words of Horowitz. A reported 46 separate leveraged loans, worth a total of more than $60 billion, have been pulled since late June. These hung deals include financing for companies such as **Allison Transmission**, **US Foodservice**, **Dollar General**, **ServiceMaster**, and **Alliance Atlantis Communications**.



> **Stern's Edward Altman: '[The crisis] could all have been avoided if investors had dug in their heels earlier and if sponsors had not been so greedy.'**

Fears are also growing that the debt crisis and the increased cost of capital that accompanies it could doom other pending mega-buyouts such as the **Texas Pacific Group** and **Kohlberg Kravis Roberts**-backed acquisition of **TXU**.

Underlying the analysis of the debt crisis' severity is the question of where the economy goes from here. For now, things still seem copasetic, but if liquidity dries up, more defaults could be in the offing, which would make lenders only more reticent. Moreover, with the subprime mess cramping the housing markets, an obvious question economists have to be wondering is whether or not the consumer can endure a prolonged real estate slump.

In the meantime, according to some market pros, sellers largely sat on their hands during July and early August, as valuation expectations took a significant hit amid the lender pullback. **Nexstar Broadcasting Group**, for example, cited the "difficult conditions" in the financing market when it announced plans to postpone its search for strategic alternatives.

And not only is debt becoming more expensive and restrictive, but lenders are less inclined to provide as much leverage. Whether buyers will make up the difference in equity remains to be seen, but most anticipate purchase prices will be dropping as a result, especially for the buyout-backed deal flow that is dependent on leverage.

A division

Most debt experts and buyout shops believe the debt markets have indeed undergone a permanent change, but if there's an unsettling component about the credit crunch, it's that nobody knows how severe the impact will be.

According to NYU Stern School's **Edward Altman**, a finance professor at the university, the main takeaway from the events of late July and early August is that liquidity has dried up for risky debt. He notes that whatever pain the market is currently feeling "could all have been avoided if investors had dug in their heels earlier and if sponsors had not been so greedy."

But even as commentators say the large-market buyout boom will be, at the least, slowed by credit problems, middle-market dealmakers say they have yet to experience any trickle down effect. For this class of investor, the fact that the JPMorgans and Citigroups of the world may be stuck writing their multi-billion-dollar bridge loans onto the balance sheet is not a concern.

"The credit crisis doesn't affect the under $100 million market," says **Patrick Hurley**, managing director of **Mid-Market Capital Advisors**.

Another midmarket player, **David Gellman**, managing director at **FdG Associates**, says that in his universe, debt spreads have widened, but only by one-quarter or one-half of a point. Gellman says that one difference between the large-cap and the mid-cap worlds is that in the middle-market buyers aren't as tied to the "high velocity" money.

One banker from a large institution calls the July debt crisis a harbinger of a new equilibrium in the market place, creating a more realistic balance between risk and reward. Prior to July's tightening, he says lenders were willing to abandon safeguards to bring in business. Now the balance of power between lenders and borrowers is more even.

Mid-Market Capital's Patrick Hurley: 'The credit crisis doesn't affect the under-$100 million market.'

Meanwhile, those who believe that July's credit squeeze is simply a "temporary" correction point to interest rates that are still historically low, default rates that remain almost nonexistent, and continued strength in corporate earnings to buttress their case that July's carnage will be contained to the debt world and not spread to the larger economy. Those who espouse a grimmer view of the debt debacle, however, also point to the loss of the private equity premium in the stock markets as a compelling reason that the damage will seep into the larger economy.

"There will be more pressure on management teams at public companies because there won't be private equity buyers waiting in the wings to bail them out," says the banking source.

David Stowell, meanwhile, a finance professor at Northwestern University's Kellogg School of Management, expects the credit markets to stabilize by 2008. But he adds that when the smoke clears, there won't be a return to the liberal lending practices of the last few years.

One group of lenders that may take advantage of the current crisis is the providers of mezzanine loans. "If there is less second lien money available, it will play into the mezzanine sector's hands," says **Ron Kahn**, a managing director at **Lincoln International**. He notes that in the smaller end of the mid-market, mezz will play a larger role in junior capital as a result of the debt market's turmoil.