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Effects of Bridge Financing on Private Equity markets

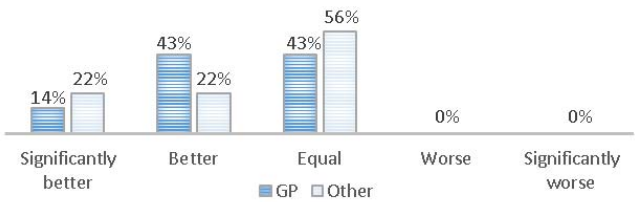
A Caplantic Whitepaper

Bridge financing is a short term loan leveraged on the limited partners' commitments to finance acquisitions made by fund managers (GPs). There are typically two main reasons why bridge financing is used. Firstly, when an acquisition needs to be quickly closed and there is not enough time to call capital directly from limited partners (LPs). Secondly, as the facility is given at the fund's level, it enables GPs to delay capital calls made to LPs, thereby facilitating the control of profitability.

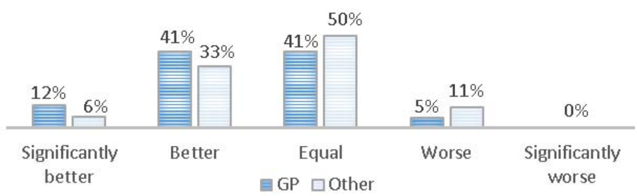
Anecdotal evidence suggests, that this mechanism is increasingly used by GPs. To evaluate how this impacts Private Equity markets, we conducted a survey among more than 200 market participants (GPs and Others such as placement agents and consultants), wherein we gathered over 80 responses (about 75% of those from GPs). The results are summarized and analysed below.

The majority of the survey's participants were either neutral or optimistic with regard to current credit availability. GPs were rather confident compared to the Others, respectively 44% for the Others and 57% for the GPs, which saw the credit market being better or significantly better compared to 12 months ago. Furthermore, none of the participants perceived the credit market negatively.

How do you evaluate the availability of credit for private equity deals compared to 12 months ago?



How do you evaluate the credit conditions/terms for private equity deals compared to 12 months ago?

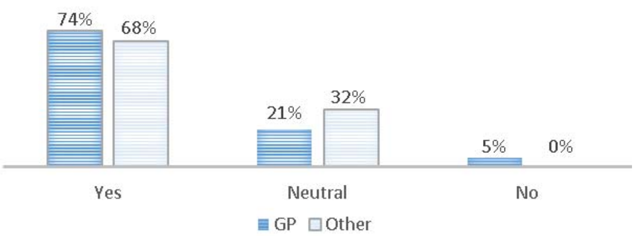


Concerning the terms and conditions of credit, the results were more mixed. GPs were once again more optimistic than the other market participants with 53% of them being positive compared to 40% for the other group. Contrary to the credit availability there were concerns from some participants as 11% of the Others and 5% of GPs expected terms and conditions of credit being worse than in the past. Nevertheless, a majority of participants didn't assume any changes.

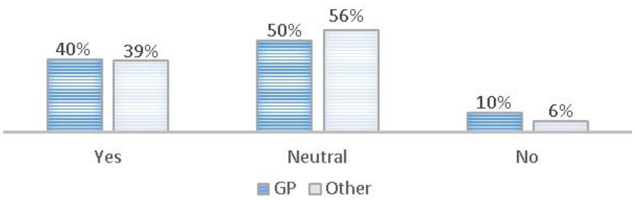
The recent record levels in dry powder (capital available to GPs for investments) in theory leads to more capital chasing a relatively steady flow of deals and thus a higher competition among GPs. This development could be further exacerbated by the increasing use of bridge financing. Consequentially, survey respondents overwhelmingly answered, that these developments do indeed lead to a tougher competition for deals.

Furthermore, a vast majority of survey participants, regardless of being a GP or not, also finds, that an increase in the capital available to invest (via dry powder and bridge financing) also leads to increasing valuations of target companies, supporting the notion of “too much capital chasing too few deals”.

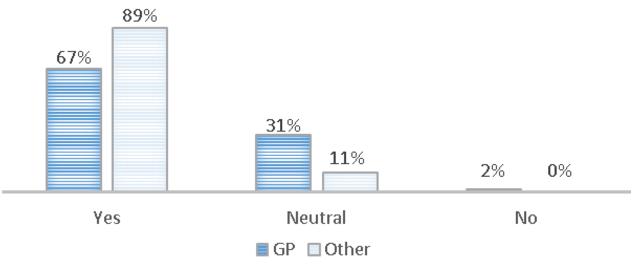
Does an increase in dry powder and use of bridge financing lead to an increase in company valuation?



Does an increase in dry powder and use of bridge financing lead to a slowdown of capital calls?



Does an increase in dry powder and use of bridge financing lead to tougher competition for deals?



As far as the impact of dry powder and bridge financing on the speed of capital drawdowns is concerned, the evidence is more mixed: While about 40% of GPs and Others believe, that there is a slowdown, more than half of the participants are neutral in this regard. The remaining roughly 10% do not find any effect whatsoever.

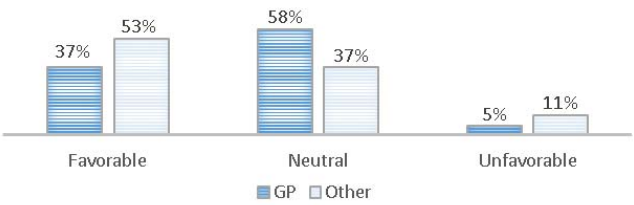
Finally, the opinion of both GPs and Others was assorted regarding the impact of bridge financing on the Internal Rate of Return (IRR). Theoretically, the use of bridge financing reduces the holding period of companies from the LPs' point of view (as the drawdown is made long after the acquisition) and therefore should increase the IRR.

In our survey, 37 % of GPs view this effect as favorable, while 58% are neutral and only 5% of GPs consider this to be unfavorable. The mixed nature of these results is probably due to the diverse background of the participants from all stages and strategies of Private Equity, who each have their own methodology and to some extent biases: On the one hand, some GPs are more focused on delivering a higher IRR to their LPs rather than higher multiples. These GPs may consequentially use bridge financing as a tool to optimize their return profile and thus are favorable about its use. On the other hand, some fund managers tend to focus more on higher multiples (or some combination of multiple and IRR) and consequentially tend to be more unfavorable.

Additionally, the GPs' view might also be dependent on their LP base: Some LPs disapprove the use of bridge financing for different reasons. One of the main reasons being, that those LPs are seeking to reduce cash drag and hence prefer their capital being called early on during the fund's investment period.

On the contrary, other investors focus primarily on IRR, for example because their variable compensation or bonus is largely determined by the internal rate of return of their portfolio.

Do you consider the impact of a potential higher IRR through the use of bridge financing as:



With our summary and analysis above we tried to shed some light on the impact of the increasing use of bridge financing on the private equity markets, as well as the underlying trends that are driving this development. In conclusion, the empirical evidence we found suggests, that the "too much capital chasing too few deals" phenomenon is further exacerbated by the increasing use of bridge financing, which is in turn amplified by the better availability and generally more favorable terms and conditions of credit. Regarding the IRR effect of bridge financing, the results are somewhat mixed, with a majority of participants being in favor or neutral.

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Private Equity International magazin published a summary of this article:

https://www.privateequityinternational.com/print-editions/2017-03/data-room-taking-the-credit/

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