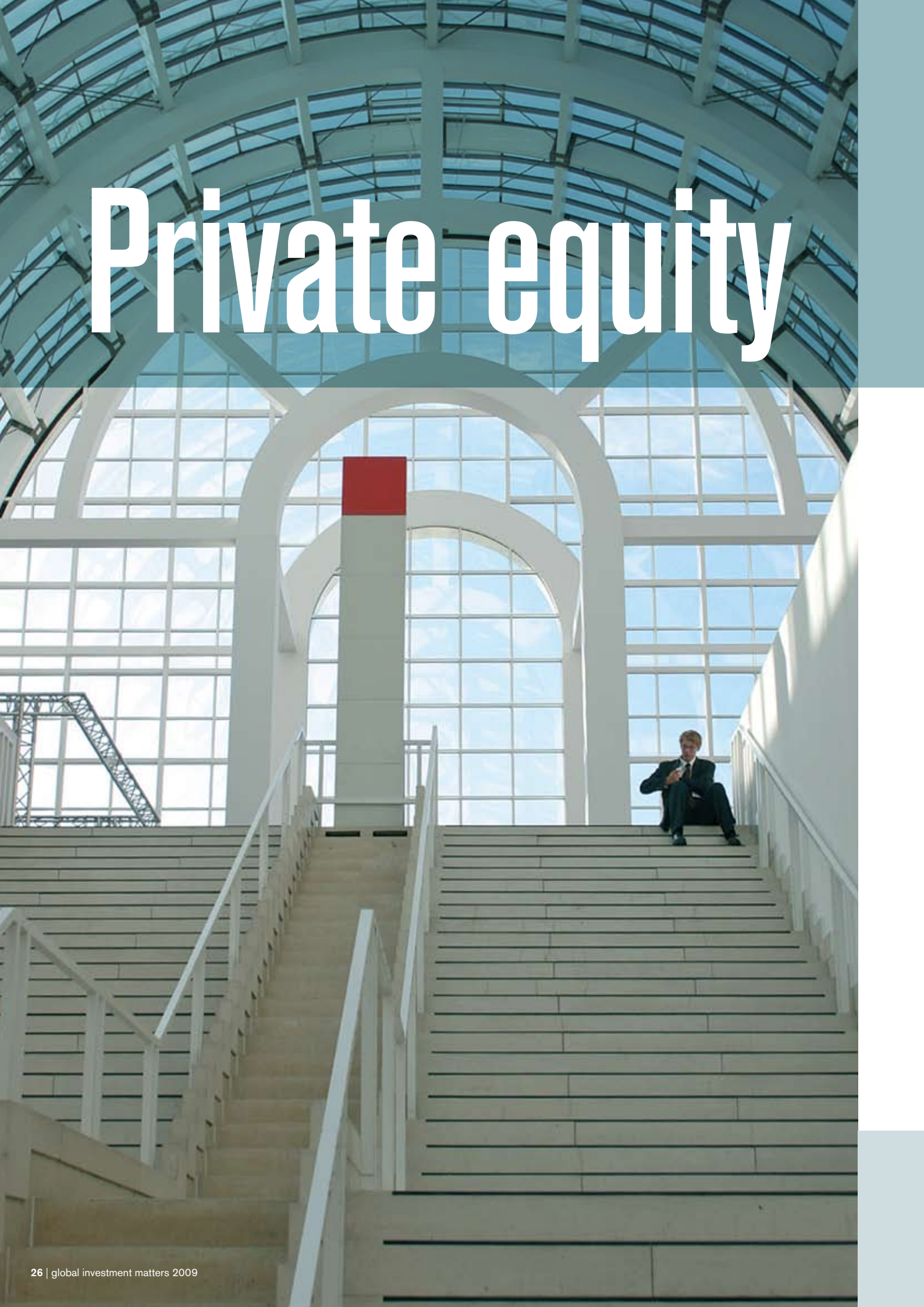


# Private equity





In September 2007, just a few weeks after the advent of the ‘credit crunch’, we wrote to our private equity clients with our views on the potential impact on the asset class of the market volatility at the time. Acknowledging that we were writing at the early stages of a significant turning point across financial markets, we made five ‘predictions’. How accurate were they? We look back at a period of unprecedented volatility in this asset class.

#### Our predictions:

- 1) Private equity managers that rely heavily on debt to finance buyouts will struggle to complete transactions – deal activity will slow.
- 2) A fall in prices that buyout funds are willing to pay for deals, as managers are forced to provide a larger proportion of equity in deals.
- 3) The days of recapitalisations providing early liquidity (and a significant boost in internal rate of return (IRR)) seem to be (temporarily at least) over.
- 4) Buyout firms will be forced to hold their investments for longer periods to give the underlying companies time to ride out market cycles prior to exit – realisation rates will slow.
- 5) Reduction in expected private equity returns from recent highs.

More than a year has passed and, while events are still moving very rapidly, we maintain conviction in each of our predictions. In this article, we update our thoughts, providing data to put the events of the recent months into some historical context and to consider some forward-looking perspectives. Below we consider a number of issues, each one referring to one or more of our five predictions.

#### Impact of credit crunch on deal volume

Credit markets changed dramatically in the second half of

2007, with banks left holding huge amounts of unsyndicated debt. In the third quarter of 2007, the credit market backlog totalled some \$340 billion<sup>1</sup>. In this light, it was unsurprising that banks’ appetite to underwrite new debt packages disappeared in short order. These conditions provided the backdrop for a remarkable fall in deal volume. To illustrate, US leveraged buyout (LBO) transaction volume in the second quarter of 2007 was in excess of \$150 billion, whilst the corresponding figure in 2008 was just \$40 billion<sup>1</sup> (see **Figure 1**). Furthermore, the vast majority of these transactions were announced prior to the credit crunch. The credit market backlog has cleared to a certain extent, moving from \$340 billion down to approximately \$110 billion<sup>1</sup> since then but, given the turmoil in the markets, we expect banks will remain very cautious in underwriting new debt packages in the near term.

#### Increase in required equity to finance transactions

Unwillingness on the part of the banks to provide debt to finance transaction, would be expected to require an increase in equity contribution from private equity sponsors. According to S&P, average equity contribution for US buyouts of companies with EBITDA<sup>2</sup> in excess of \$50 million fluctuated around 30 per cent between 2003 and 2007, but the average in the second quarter of 2008 spiked to 40 per cent.



Private equity managers have been faced with a difficult decision, whereby if they want to complete transactions, and thus deploy the huge chests of capital they have recently raised, they have to finance them with more of their own capital rather than that of the banks. All other things being equal, this must decrease the expected attractiveness of a deal. See **Figure 2** for an illustration.

### Exit environment

The period between 2005 and 2007 was characterised by the 'leveraged recapitalisation'. This involves restructuring a portfolio company's capital structure, typically resulting in increased debt for the company accompanied by a dividend paid out to the equity investors. This, therefore, provided liquidity to private equity investors in exchange for an increased interest burden for the underlying business. As we predicted last year, once the credit crunch struck, this option soon disappeared for private equity managers. Indeed, many portfolio

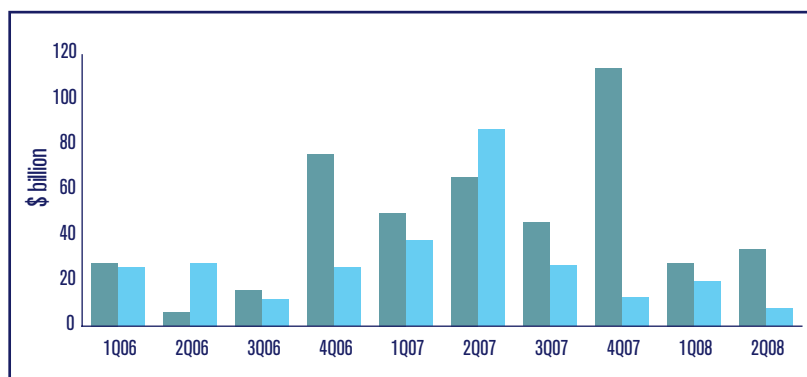
companies that underwent leveraged recapitalisations now find themselves hindered by this increased debt burden and consequently their medium-term prospects have become less attractive. Private equity managers have found full exits for these businesses particularly difficult.

In addition to the loss of the recapitalisation as a liquidity avenue for private equity managers, equity markets have been volatile over the last year, with the S&P 500 Index falling 38.4 per cent in 2008<sup>3</sup>. As a result, finding an exit route via the public markets at an attractive valuation has also been problematic for private equity investors. Ongoing equity market volatility combined with current economic uncertainty across the globe suggests that the exit environment will remain difficult for the foreseeable future.

### What does the future hold?

Thanks to longer expected holding periods, less availability of and more expensive leverage, a more challenging exit environment and the disappearance of the recapitalisation as a liquidity tool, we expect private equity returns to fall from their recent highs. Notwithstanding early recapitalisations providing boosts to IRRs for 2005–2007 vintage year funds, we believe ultimate returns from these vintages will likely lag those of funds raised between 2002–2004. However,

**Figure 1 | Total US LBO transaction volume**



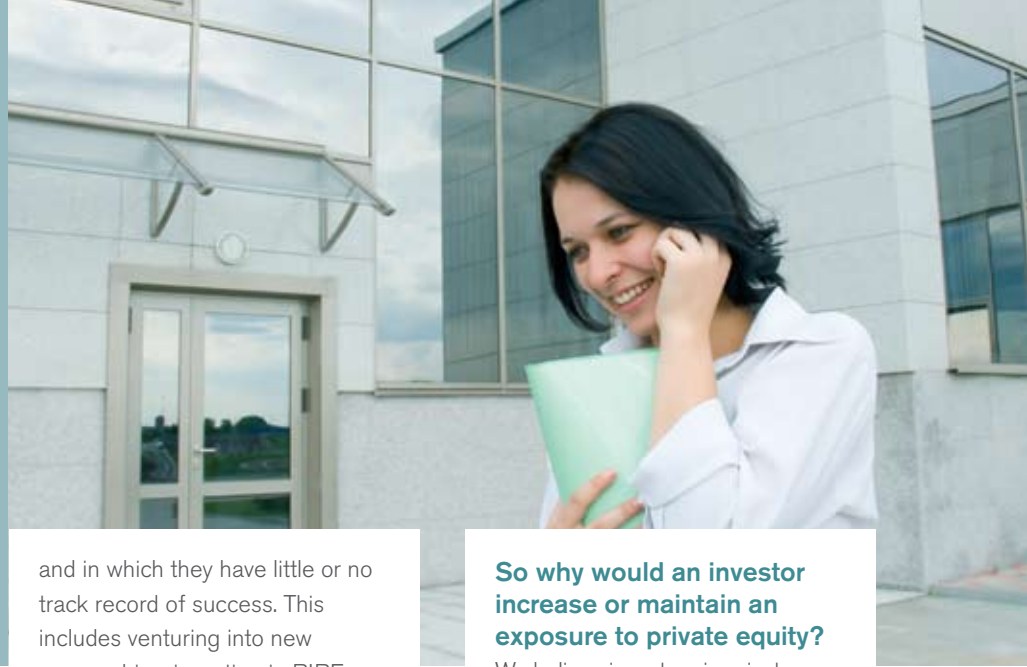
■ Public to private ■ Other LBO

Source: Lehman Brothers

**Figure 2 | The power of leverage (assuming entry and exit multiples are identical)**

Changes in company operating performance	Five year IRR at a 30% equity	Five year IRR at a 15% equity
+20%	11%	19%
+35%	17%	27%
+50%	22%	34%

Source: Watson Wyatt



market timing in private equity is something that we strongly believe should be left to managers, rather than undertaken by investors. Long-term, experienced private equity investors have learned to accept that returns are cyclical and a consistent commitment approach is necessary to generate sustainable, strong performance. The recent boom period has generated exceptional returns for almost all private equity investors. However, going forward, we expect a larger disparity between the most and least successful private equity funds as those managers who are equipped to deal with the current downturn outperform those who have relied on unsustainable drivers of returns.

Due to the aggressive leverage used to finance transactions between 2005 and 2007 and a weakening global economic climate, we expect a number of the larger private equity backed buyouts to face defaults and ultimately bankruptcy over the coming years.

In addition to problems within their current portfolios (due to the credit market problems noted above), some of these larger managers who raised unprecedented pools of capital through 2006 and 2007 are now facing capital deployment problems. This is giving rise to style drift, whereby managers are pursuing strategies that are largely inconsistent with the story they told investors during fundraising

and in which they have little or no track record of success. This includes venturing into new geographies, investing in PIPEs (private investments in public entities) and making minority investments, the latter two of which do not give private equity managers the level of ownership or control required to be pro-active, hands-on owners of businesses – one of the key reasons why investors pay private equity fees. We welcome imagination and innovation from private equity managers, but there is a fine line between innovation and desperation and investors must be aware of the dilemma currently facing some private equity managers.

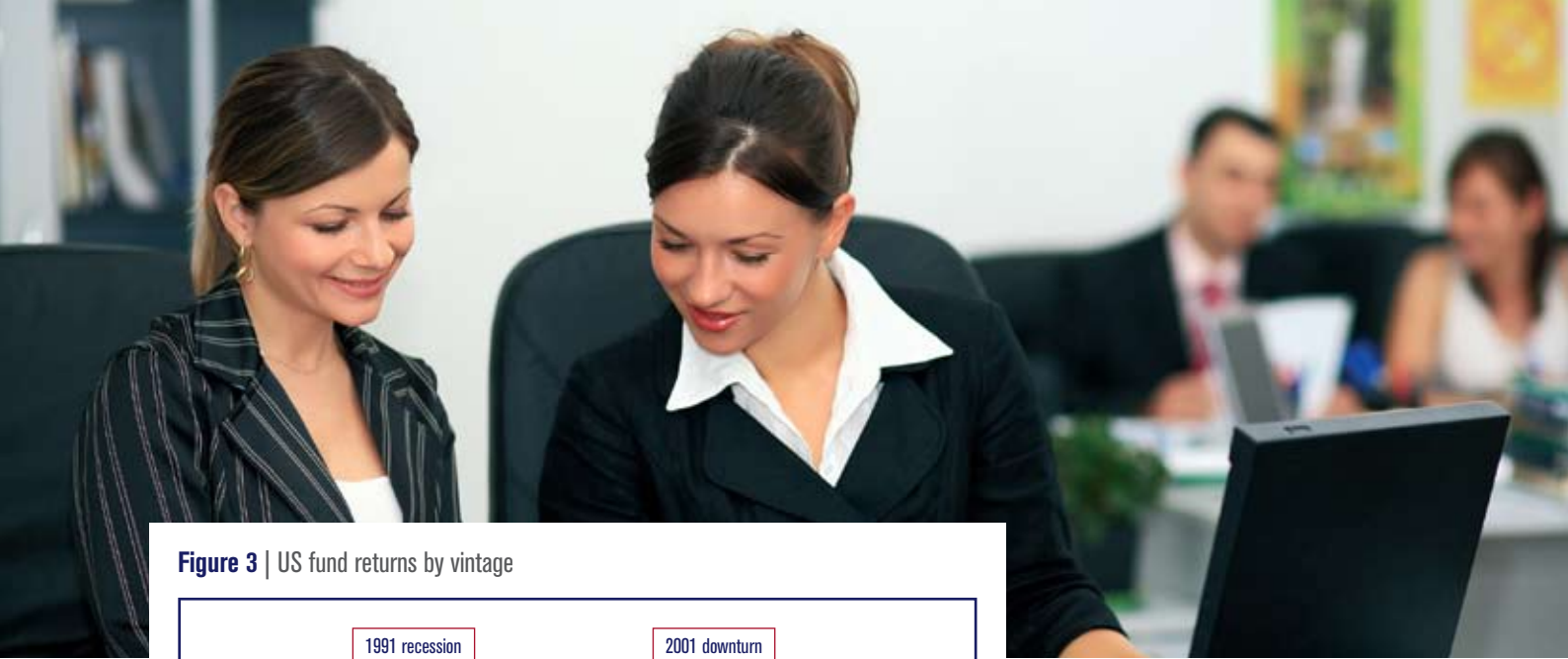
It is worth emphasising that this kind of deployment issue broadly remains a large and mega-cap phenomenon as mid-market managers have less capital to deploy and are generally less reliant on the debt markets to complete transactions. This emphasises the importance of a private equity investor maintaining a sensible level of diversification within a private equity allocation by size of investment. Appropriate diversification by size, year, geography, stage and manager should maximise an investor's chances of generating consistent private equity returns over the long term.

### **So why would an investor increase or maintain an exposure to private equity?**

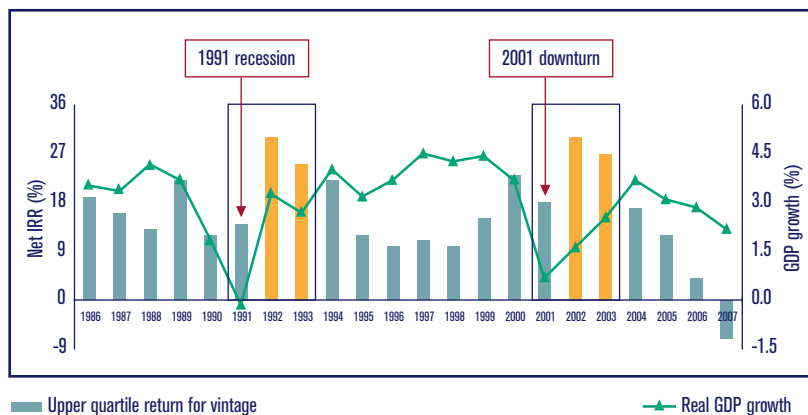
We believe investors in private equity should adopt a long-term approach and avoid trying to time the market. However, whilst the headlines (which focus almost exclusively on the larger, high profile transactions and firms) suggest dark times ahead for the asset class, we believe now could be an interesting time to selectively invest in private equity. Indeed, it is during these periods of adversity that private equity managers have achieved significant returns for investors in the past. Furthermore, if the pricing environment softens, as many managers expect will be the case, private equity managers will be well positioned to buy good quality businesses at more attractive valuations than have been available over the past couple of years.

**Figure 3** shows how some private equity managers have enjoyed strong performance in periods of economic downturn. The key for a private equity investor is to select managers with a proven discipline of waiting patiently without deploying capital if the pricing environment is unappealing.

Once a manager is able to acquire a business at a reasonable valuation, those managers who are able to genuinely add value to their portfolio companies by providing operational and strategic input will be best positioned to drive returns



**Figure 3 | US fund returns by vintage**



Source: Lehman Brothers

on equity through a period of economic uncertainty. Financial engineering is a commodity and private equity investors can no longer rely on this as a sustainable driver of returns.

In addition to operationally skilled private equity managers, we believe managers with a proven ability to turn poorly performing businesses around and selectively invest in distressed situations will generate attractive returns over the near term. If implemented by high quality managers, distressed investing can provide investors with attractive returns across the credit cycle. It also offers scope for excess returns to be earned as the credit cycle creates this additional supply of opportunities.

### Conclusion

There is little doubt that market participants will look back to the recent past as a period of excess in private equity. Managers took advantage of a significant tailwind working in their favour. Cheap and readily available debt combined with rising prices and an accommodating exit environment allowed private equity managers to generate strong returns for investors without needing to exercise particularly high levels of skill and investment judgement.

That era is over. Financial engineering has become a commodity and private equity managers can no longer rely on multiple expansion to generate returns. Private equity returns on average are likely to fall to more normalised levels from the extraordinary levels seen in recent years.

The successful private equity managers will be those who can remain disciplined through an uncertain period for the industry. Successful managers will balance innovation in getting transactions done, while avoiding the temptation of strategy drift. Managers with strong track records of creating value through faster earnings growth from their portfolio companies are likely to excel during this demanding period.

In light of these challenges, we believe that long-term private equity investors will be rewarded for selectivity once again.

<sup>1</sup> Lehman Brothers

<sup>2</sup> Earnings before interest, tax, depreciation and amortisation

<sup>3</sup> Bloomberg