OPINION

Challenging times for private equity

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Private equity – at least the large buyout space – is today faced with four main challenges: performance, financing, raising new capital and managing existing investors.

Performance

Any of the large buyout deals concluded between late 2005 and the first semester of 2008 appear to have been overpriced and overleveraged. Aggressive debt packages were often structured on the basis of rather rosy projections and often with insufficient due diligence to identify important issues (key contracts, manufacturing capital expenditure needs, etc). While the relatively loose covenants originally obtained by private equity sponsors seemed to the advantage of the equity investor, it also led to weaker control mechanism for banks and the underlying companies.

This means, possibly, that bigger risks were in fact taken than would have in a "normal" market. Today, as a many economies around the world tend to weaken, many of the underlying companies' performance seem to perform below plan. In some cases, on a mark-to-market basis, this translates in deals loosing their full equity value.

This is most visible in certain sectors (automobile, retail, leisure) but possibly in many other "defensive" industries (healthcare or food).

The real question today is whether these investments will survive the pressure of their debt repayments in the short- to mid-term, and be able to live through the cycle to regain value. So long as the companies are not bankrupt and not sold, their equity sponsors' equity loss is only virtual. And the good news for some of these recent deals is that they often benefitted from long-term financing with no intermediary repayment obligations. Until then, private equity fund managers can only hope for better times to sell (before their bullet payment becomes due), and generate equity gains.

The fact remains nonetheless that not all funds will be profitable in 2009 and, yes, that one can lose money in buyout transactions (a possibility that seemed so slim in 2006-2007). Private equity is an attractive asset class when managed by dedicated professionals. It is also an illiquid asset class and needs to be assessed with a long-term view. Hence, performance needs to be analysed before making hasty conclusions.

Financing

With regards to new deals, today's credit markets are still making it very difficult for private equity managers to find leverage for large – as well as middle market – buyout deals. This means that it is challenging for these groups to put money to work.

Only those private equity sponsors using no or little leverage are able to execute deals. Some groups have managed to raise their own debt funds to bypass their needs for banking financing, but this only works for smaller amounts and for a limited time. This, by the way, is also being criticised by limited partners who see it as a pure strategy drift. In the end, to generate the expected returns, equity sponsors will need to find refinancing solutions for their deals – the sooner, the better!

Another important deal closing factor is pricing. On average, it still appears that price expectations from sellers have not yet come down where buyers would want them to. It is only a question of time before expectations meet. Given the need for many industrial groups to reorganise themselves, or private equity funds to find exit solutions for their holdings, prices will eventually come down.

If this occurs when financing becomes again available, it will mean lots of attractive opportunities for private equity players (especially if interest rates remain as low as they are today). Private equity groups that have raised money (and hold large pools of undeployed money) and have built strong networks with such potential sellers are best positioned to reap the early benefits of the situation change.

Fund-raising

A large majority of investors around the world have decided to put their deployment on hold or at least reduce the amount of money to put at work on the markets. In fact, many of them are selling their private equity fund interests via the secondary market with a view to bring their portfolio profiles in line with their overall portfolio allocation strategy for the short- to mid-term.

¶¶Sellers are disposing of mature as well as more recent vintages, targeting the right balance between their exposure objectives and liquidity requirement. For those who are still investing in primary funds, their selection processes have become more stringent and are taking longer. Raising new funds in this environment is very demanding not to say impossible for teams with poor performance and lack of strategy dedication. It is quite possible that some teams will disappear in this environment as they fail to raise their next fund. Industry consolidation is hence on its way in many regions.

> Finding buyers in today's market requires market insight and extensive transaction experience

Another development we have observed is how early secondaries (the purchase of very recent unfunded funds on the secondary market) have cannibalised part of the monies available for primary deployement. Indeed, buying a secondary interest in a fund less than 20 or 25 per cent called, basically consists of a primary commitment in this funds. Great opportunities are being seized in the market by savvy investors... and not necessarily at the absurd prices leaked in the press.

LPs defaulting

As it was the case with the internet bubble burst in 2001, the market has observed the resurgence of limited partner defaults. For such investors, there are usually two reasons to default: internal liquidity constraints or willful default (activist).

In both cases, one will hope that they anticipate that moment early enough and access the secondary market to find the needed liquidity or dispose of the non-core relationship.

In the case of LPs going broke too quickly, they are rare and often result from poor anticipation and portfolio management skills. The secondary market, when approached in a timely and efficient fashion, can often provide optimal solutions to limited partners in situations of distress or looking to rebalance their portfolio.

As mentioned earlier, the market can also provide early release solutions to investors in recent funds (very unfunded). Finding buyers in today's market requires market insight and extensive transaction experience, but can still prove successful for both sellers and buyers.

Overall, the main challenge facing private equity around the world is to continue to prove that it can be a powerful creator of value for investors. While large buyout has attracted many of the headlines (good and bad), it is far from being the only one strategy available to investors in that space. Today's market is a healthy reminder that one needs carry out careful due diligence when looking to invest in the asset class and be certain to allocate across multiple strategies and teams with demonstrated track records.

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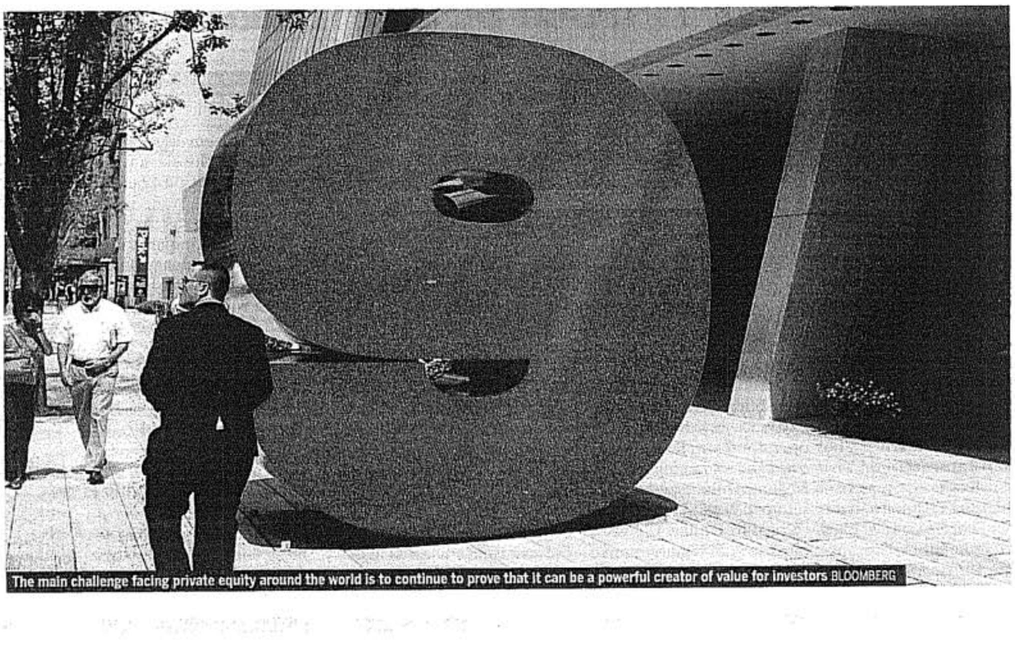

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