PRIVATE EQUITY – BEYOND THE RECESSION

by Dr. Dirk Schneider

The mid-term impact of the 2008 / 2009 financial crises will change the Private Equity industry. The industry will undergo consolidation with a smaller number of players dominating the market. These winners will require additional skills-sets beyond their traditional finance-dominated capabilities. Who will be among the winners? Which capabilities will be required in the future?

The following article provides a framework to identify likely winners of the already ongoing consolidation and it analyses the additional capabilities most likely needed in the upcoming years. It helps investors in Private Equity to adjust their investment selection and it guides managers of Private Equity firms to prepare their firms for the upcoming years.

The financial and economic environment still is far away from its pre-recession heydays. But coordinated initiatives of governments and central banks have prevented a melt-down of the financial systems. GDPs and financial markets have stabilized surprisingly quickly and the likelihood of a prolonged recession appears low. Two scenarios are likely.

In the best of all worlds financial and economic confidence will return quickly, international trade regulation and inflation will remain benign and economies will return to pre-crises levels quickly.

More likely, however, confidence will remain shaky for some time. Regulatory and inflationary uncertainties will leave their impact. Reoccurring hiccups in economic growth and financial markets will lead to an unstable recovery with some years before returning to pre-crisis levels.

How will this impact Private Equity? What will drive success 2010 to 2015?

Private Equity will see a shake-out but remain strong as an industry

While some players will fall prey to an industry shake out, the industry itself will remain strong. Winning players will continue to earn superior returns.

The pre-2008 years have been extraordinary fundraising years for Private Equity. With more than US$ 500 billion left to invest, the industry overall is in a comfortable cash situation (Exhibit 1). These funds, however, are not equally distributed among private equity firms and the ones who need to raise fresh capital soon may face a highly competitive market place.

Most investor groups – with the notable exception of financial institutions and possibly family offices and endowments - do not plan to scale down their relative private equity exposure. Some pension funds and insurance companies even consider to increase their exposure like Allianz, the German insurance group which discusses to double its private equity commitment. Successful fund closings remain possible as, e.g., CVC, Heilman & Friedberg and Clayton Dublier & Rice demonstrated in 2009. But investors may delay new commitments until their overall portfolio has stabilized so that they can adjust their asset class weightings to reflect new valuation levels and their possibly adjusted risk- / return-appetite. In addition, they may become more selective in choosing their partners.

A comforting long-term track record – and prudent investment decisions in 2006 and 2007-, an investment strategy matching the current environment as well as an investor-base not too dependent on financial institutions may prove decisive to attract new funds. Private equity firms lacking these might face a difficult uphill battle in closing new funds and in any case, fund raising may prove to be more time consuming than in the past.

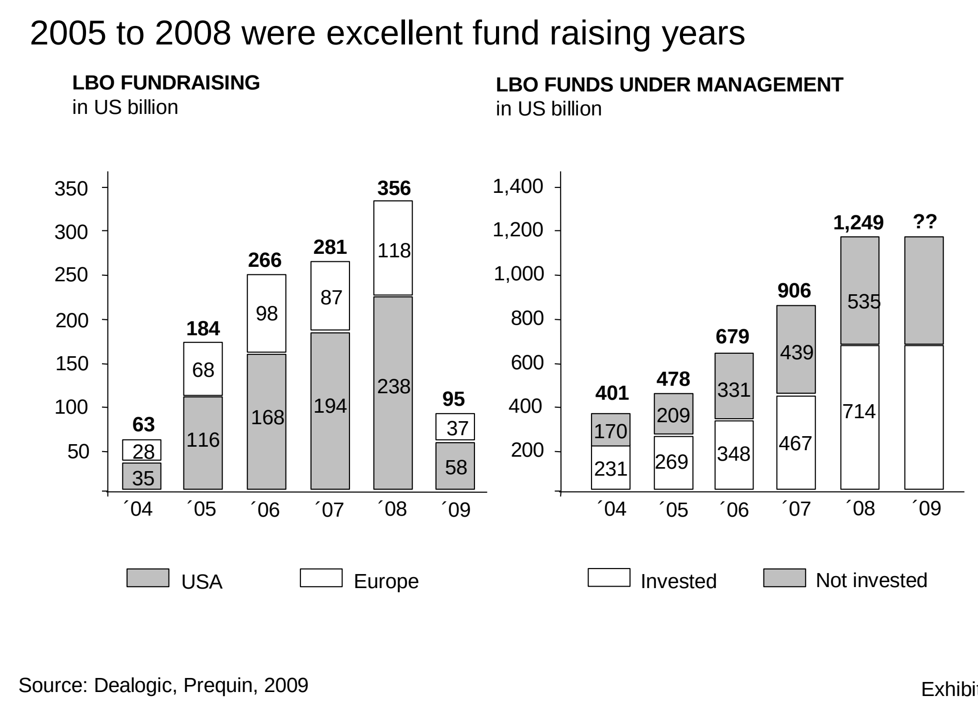


Exhibit 1

Likewise, the pre-2008 years have been extraordinary financing years for leveraged buy outs. With more that US$ 600 billion highly competitive LBO loans available in 2007 alone (Exhibit 2) fund managers could structure highly leveraged and seemingly attractive transactions.

When employed early in the multiple expansion phase or to refinance dividend payouts for existing investments those loans usually contributed to attractive returns. A 2009 study conducted by Bain & Co. actually concludes that during 2002 to 2007 almost the entire return could be attributed to leverage and market driven multiple expansion. When used to fund increasingly high acquisition multiples - especially in 2007 and early 2008 (Exhibit 3) – the availability of these loans, however, has fuelled a bidding competition not only leading to highly leveraged but also overpriced transactions, many of which already requiring restructuring.

One example for unhealthy leverage and overpricing towards the end of the bubble is the acquisition of Bavaria Yachtbau by Bain Capital in 2007 for a reported € 1,1 billion - at roughly 14 times EBITDA and 4 times revenues highly priced and with 80% debt aggressively financed. When the recession hit, Bavaria even with significant sales losses could maintain an operating profit but was unable to serve its debt obligations. In the following financial restructuring Bain Capital and the financing banks Goldman Sachs and Commerzbank had to write off a reported € 800 million and effective ownership moved to Oaktree and Anchorage Advisors, two investment firms specialized in distressed situations.

Players with a large share of such highly leveraged investments - in particular in recession-prone industries like automotives – are already facing a severe need for financial and operational restructuring in their portfolio. These restructurings drain heavily on internal resources – both financial and managerial – and might prevent some players from focussing on new opportunities arising in the current environment.

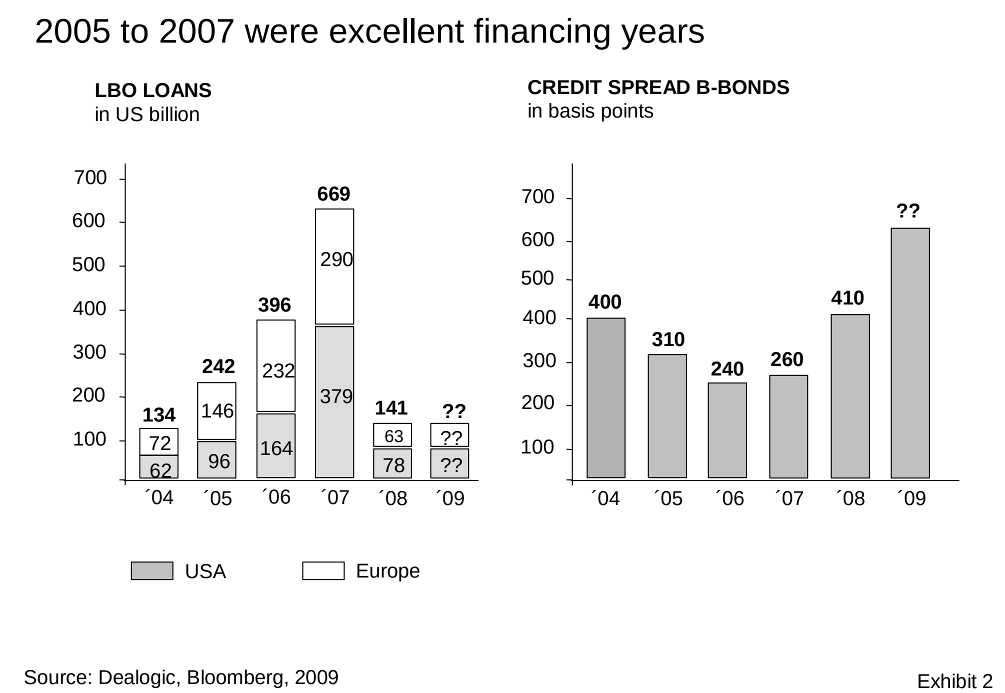
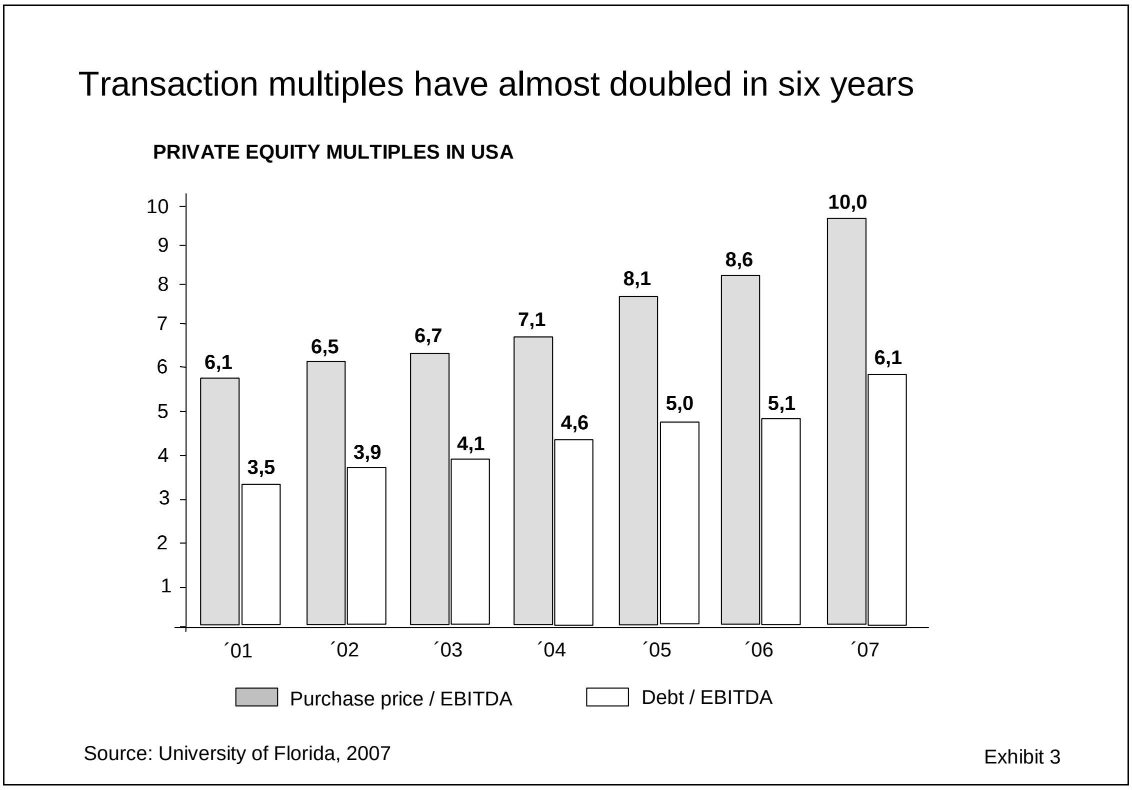


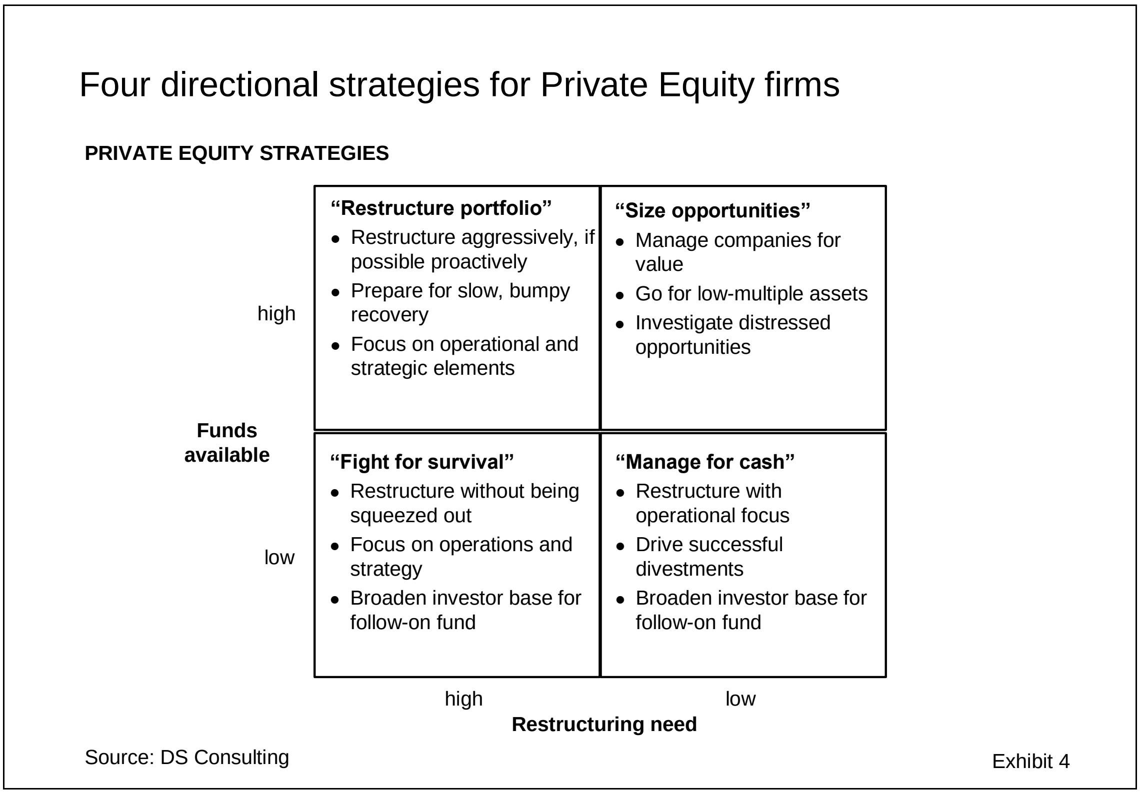
Exhibit 2

The combination of cash availability and restructuring need of various private equity firms leads to four generic strategies for the next few years (Exhibit 4).

Private equity firms with sufficient funds available and low restructuring needs among their portfolio companies can **size on a variety of opportunities**. They have the resources to maximize the value of their existing investments. They can also scan the market for attractive, low-multiple opportunities and pay special attention to distressed opportunities in other portfolios or within industrial conglomerates. Especially with a combination of strong financial and operational restructuring skills they can find and manage the high IRR investments often found in down-turn economies. They will be winners of the upcoming industry shake out.

At the other extreme, private equity firms with low funds available and high restructuring needs among their portfolio companies will have to **fight for survival**. Not being able to participate significantly in any balance sheet restructuring they might have to dilute their equity stake even at the risk of being maginalized. Their survival will depend on their ability to manage the operational and strategic restructuring and claim a sufficient part of the value rescued. Many firm in this category, however, might not succeed and fall prey to the industry shake out.





Private equity firms with high equity reserves and high restructuring needs among their portfolio companies need to **restructure their portfolio** aggressively. In some cases this may be possible out of a position of relative strength, possibly even before covenant restrictions have been violated. If those firms can employ strong financial and operational restructuring skills they might end up as winners of this industry shake out as well.

Private equity firms with low equity reserves and low restructuring needs have to **manage for cash**. Given their restrictions to participate in financial restructurings they should focus on short-term cash relevant operational levers in their portfolio companies to support any broader restructuring where needed. In parallel they should drive their more stable investments towards successful divestments in order to strengthen their position for a new fund raising round. Their position after the industry shake-out will be largely determined by their ability to attract fresh capital.

These generic strategies are, of course, not sufficient to determine a course of action for any individual firm but they will help to structure a critical review of each firm's position and to provide focus for the next years.

In addition, all private equity firms need to prepare their portfolio companies for a longer and bumpier recovery than many are hoping for. Close attention to operational performance and longer-term funding requirements will be key. Attractive new investment opportunities are likely to shift towards restructurings at company or industry level.

Distressed investments and industry consolidation will gain relevance

Private equity firms in the position to seize new investment opportunities will face an environment different from the pre-2008 period. "Mega-LBOs" with more than US$ 3 billion will remain difficult for some time and even large buy-outs in the range of US$ 1 to 3 might prove challenging. Mid-market opportunities will continue but not at sufficient levels to adsorb the US$ 500 billion buy-out funds still un-invested in the market. Further opportunities will arise in the distressed arena as well as in strategically driven segments, e.g. industry consolidations or supply chain integrations.

"Mega" or large LBOs the primary driver behind the 2005 to 2008 boom, will at least for some time suffer from the reduced availability of large debt financing. While new regulatory rules on private equity firms themselves should remain modest, financial institutions will face tighter requirements limiting their ability to provide large debt financing. Together with a general need to de-leverage, financial institutions might not be able to resume their financing role for some time. Capital markets for corporate debt have recovered recently but still have to prove their depth. The successful US$ 3 billion acquisition of Springer by EQT has set a positive note. And the financing package for the rumoured US$ 7 billion acquisition of Kabel Deutschland by CVC Partners and Carlyle will provide further insights. Overall, this segment of the market will not be dead but may play a less dominant role in the years to come.

Mid-market buy-out opportunities between less than US$ 100 and up to US$ 1 billion will continue and private equity firms will find the debt financing to close these less sizable transactions although at lower leverage than in the past. With acquisition multiples again in a more sensible range and the outlook of a bumpy but nevertheless recovering economy these transactions may well provide for attractive IRRs. Their combined volume, however, is unlikely to adsorb the more than US$ 500 billion buy-out funds still un-invested in the market and with lower leverage, returns will be increasingly driven by active operational and strategic improvements of portfolio companies.

The number of **distressed opportunities** will increase – similar to the Bavaria Yachtbau example outlined above. To return the same IRRs in this arena as in highly leveraged buy-outs, firms will have to embark on comprehensive restructurings including financial, operational and strategic initiatives. On the financing side, private equity firms may have to expand their financing instruments to include for distressed debt and other non-traditional instruments. On the portfolio management side, they may have to provide even closer operational and strategic support to their portfolio companies.

Strategically driven opportunities, e.g. **industry consolidation or supply chain integration** will continue and might play a more significant role in the future. Private equity firms focusing on this arena will require detailed strategic insights into the respective target industries and the operational skills to manage, e.g. a multi-step acquisition and integration program. With these skills in place, this arena may well deliver the IRRs formerly seen in highly leveraged buy-outs.

Attractive investment opportunities will continue. With "Mega LBOs" declining for some time, mid-market, distressed and strategically driven opportunities will become the likely focus for the next years. For private equity firms this may imply to adjust their focus accordingly. Triton Partners' third fund with a first closing end of 2008 already targets specifically restructuring and buy & build situations. Some former pure equity players like Alchemy have set up debt and special situations vehicles while some previous pure debt player like Strategic Value Partners have migrated into the equity space.

To fully capture these opportunities, private equity firms need to continue to strengthen their industry expertise and broaden their operational and strategic skills. Generic LBO skills, although remaining key requirements, may not be sufficient to provide the target returns in the current environment.

Operational capabilities and specific strategic expertise will drive success

According to a 2008 study by Goldman Sachs and BCG, the sources of value creation in private equity have gradually shifted the 1980s from financial leverage to multiple expansion and earnings growth and are bound to embrace operational improvement.

While this trend will not be one-directional over time – 2005 to 2007 has shown a remarkable revival of the "financial leverage period" - it may prove to be a good predictor for the coming years. With the imminent restructuring need in many portfolios and an increasing number of distressed and industry consolidation opportunities operational and strategic capabilities will gain in relevance and possibly become the main value drivers for the next years.

Operational capabilities must be hands-on. In restructuring situations, private equity firms need the skills to manage, e.g., working capital, cost reduction or revenue growth programs in their portfolio companies almost on a shop-floor level. To implement buy-and-build strategies they need the skills to manage the post-acquisition integration or to direct selected critical integration efforts to ensure that targeted synergies really do have an impact on top- and bottom line.

Specific strategic expertise can be industry or situation related. The current environment provides opportunities, e.g., in the struggling financial sector. With a deep understanding of strategic dynamics, regulatory developments and potential industry "end-games", private equity firms can profitably participate in the restructuring of this industry. With specific situation expertise, e.g., in restructuring individual companies simultaneously along balance sheet, operational and strategic dimensions, private equity firms can effectively participate in many of the distressed situations currently arising.

Operational and strategic capabilities will not replace superb network access and deal making skills – those will remain the bread and butter of private equity. But operational and strategic skills will be required in addition to earn above average IRRs.

For private equity firms this requires a make-or-buy decision. Depending on the situation of their portfolio companies and their expected investment focus for the next years they may source these skills externally or develop them internally. With limited restructuring need and a continuing focus on LBO situations, these skills may be available on economical terms from specialized, highly skilled providers on an as needed basis. With more substantial restructuring need and potentially increasing investments in distressed or strategically driven situations, it may be more attractive to develop those capabilities inhouse to ensure sufficient quality and seamless alignment with the investment objectives of the firm. In addition, financial investors may find benefits in teaming up with strategic investors to leverage each partner's specific strength.

Conclusion

So how will the aftermath of the recession impact Private Equity? If the economic recovery will be quick and strong the impact might be modest.

In the more likely case of an unstable recovery the impact, however, will be more profound. A sizable number of private equity players may disappear and the remaining firms may expand their investment arena to include more distressed and strategically driven opportunities.

What will drive success in 2010 to 2015? If the economic recovery will be quick, private equity firms will face a short-term need to restructure their portfolio companies. But rather soon the traditional success factors of superior network access and deal closing power will dominate again.

In the more likely case of an unstable recovery, additional operating and strategic skills will be needed to address ongoing restructurings as well as distressed and strategically driven investments. Successful players will integrate these skills seamlessly into the overall investment approach and continue to earn superior returns even in a more demanding economic environment.

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