# VENTURING BACK INTO PRIVATE EQUITY

Many investors who retreated during the financial crisis are re-emerging to find new challenges — and opportunities.

BY JEFFREY AMLING AND BOB DUFFY

In 1989, Michael Jensen, a professor at the Harvard Business School, predicted that by the turn of the century, private equity firms would have taken over a large fraction of *Fortune* 500 companies. That seemed improbable then, when private equity was identified mostly with a few unpopular leveraged buyouts. But during the next two decades, as the benefits of the private equity model were demonstrated again and again, Jensen's case began to seem prophetic. By 2007, private equity transactions accounted for a quarter of all global merger and acquisition activity, half of leveraged loan volume, a third of the high-yield bond market and a third of initial public offerings.

But then, as most investors know all too well, everything changed. The global credit squeeze and the recession retarded private equity's surge, and though the industry has begun to regain momentum, the fragility of the economic recovery and a convergence of market forces continue to hinder progress. There is a backlog of investments that are behind plan, some firms have returned capital to investors, and many continue to sit on the sidelines, waiting until more attractive capital opportunities materialize. Several firms have been unable to raise fresh capital to the degree they have in the past.

Amid this turmoil, those in the private equity industry are searching for the logical next step as they consider an altered landscape that includes the following:

**Tighter lending, smaller deals, dearth of targets.** The effects of tighter lending terms both in financing new acquisitions and in managing the companies already in firms' portfolios continue to be felt. The $50 billion in capital that the industry raised globally during the first quarter of 2010 is a fraction of the capital that came in at the 2007 peak. The size of deals has also declined, with the average transaction in 2009 weighing in at about $100 million, compared with $435 million during 2007. At the same time, however, there's an estimated $500 billion in unused capital commitments, or "dry powder," raised prior to the financial crisis that must be put to work or likely will be returned to investors. With a relative dearth of attractive

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acquisition targets, prices might increase to levels that could cut into investment returns.

**Fewer exit routes and longer holding times.** Even if global financial markets have stabilized, exit routes via strategic sales to corporations, secondary sales to other firms and initial public offerings have been limited, although that situation should improve as global markets and economies recover. In global stock markets, there is a growing queue of private equity–backed companies waiting to go public. Because firms are being forced to hold on to companies in their portfolios longer than expected, they are also being forced to refinance loan obligations and use high-yield bonds (attractive to investors at a time when interest rates are very low). This trend will likely accelerate as firms address a "maturity cliff" of more than $600 billion in leveraged buyout–related

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loans in 2014 alone, and these longer hold periods are therefore likely to reduce the investment returns from levels that were realized in previous cycles when hold periods were shorter.

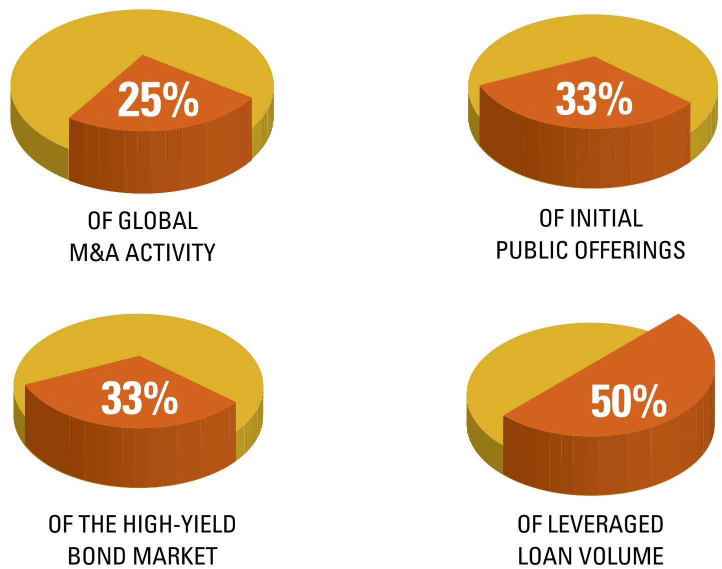
**A renewed focus on operations.** During private equity's prerecession boom, debt-to-equity ratios were as high as roughly six times EBITDA, up from roughly four times EBITDA in 2002. Today the pendulum has swung in the other direction, with equity stakes in portfolio companies now often surpassing 30%. Against this backdrop, private equity firms are seeking to bolster the performance of companies they hold by increasing hands-on involvement and focusing on operational and strategic improvements. Firms are beefing up portfolio functions and hiring executives with operating experience to assist or replace management in the companies in which they invest. In many cases private equity funds are specializing in particular niches, which helps them dig deeper in analyzing those sectors and ratchet up due diligence into potential targets to make sure industry sector issues or investment risks aren't overlooked. Anticipating and minimizing post-purchase liabilities is crucial — and particularly challenging as private equity firms expand into the developing world, where gray areas in taxation, accounting, governance and other issues can make it difficult to assess the true value of assets.

**Governance and transparency.** The recently passed U.S. reform legislation, as well as similar proposals in Europe, will force private equity to become more public, with many firms required to register with regulatory authorities and to disclose fund holdings. Global banking reforms mandating higher reserves, along with possible changes in accounting and taxation, are also adding complexity.

Additionally, in September 2009 the Institutional Limited Partners Association (ILPA), a Toronto-based network of institutional investors, set forth new Private Equity Principles to refocus attention on the alignment or identity between the interests of general partners and limited partners and to call for greater transparency, enhanced fund governance and more favorable contractual terms.

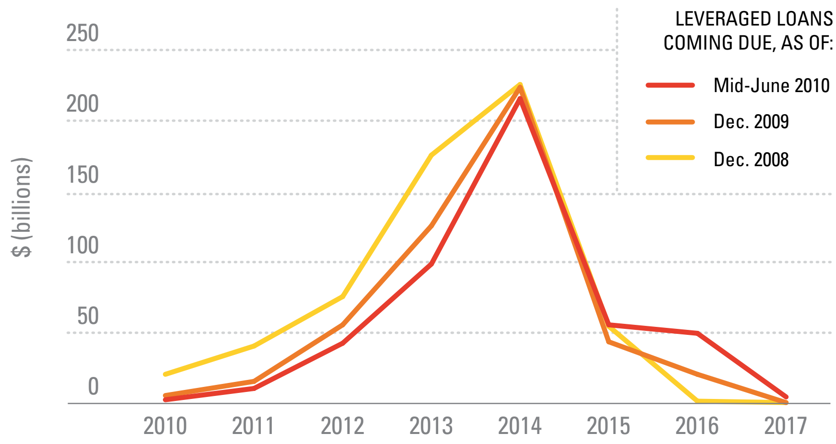
## PRIVATE EQUITY DURING THE BOOM

***In 2007 private equity deals formed approximately:***



## THE MATURITY CLIFF

***Throughout the next seven years, billions of dollars in leveraged buyout–related loans will come due.***




*Source: LCD — Leveraged Commentary & Data*

**Expanding opportunities.** Despite current market stresses, institutional investors around the world plan to increase their commitments to private equity investments, according to a recent survey on alternative investing by Russell Investments. Survey respondents in North America expect the percentage of private equity in their portfolios, currently averaging 4.3%, to increase to 6.8% by 2012, compared with projections of 3.7% in Europe and 2.5% in Japan. In Australia private equity allocations were reported at 3.5% for 2009, with little increase expected by 2012.

Much of the new investment may find its way to opportunities in the emerging markets of China, India and Brazil, among other countries. Another recent survey, of 151 pensions, foundations, endowments and other institutional investors from North America, Europe, Asia, Africa, the Middle East and Latin America, found more than half of respondents saying they planned to accelerate commitments to private equity in the developing world during the next two years.

**Image and branding issues.** Recently the private equity industry has been frequently targeted by politicians and the media for its lack of transparency and accountability. Yet many academic studies have shown that private equity firms indeed can be a positive force, creating jobs and spurring companies' sales growth, cash flow and profitability. A 2008 World Economic Forum study, for example, concluded that private equity–owned companies generate more jobs and are better managed than similar companies with different ownership structures. Now advocacy groups such as the U.S. Private Equity Council, formed in 2007, are seeking to publicize some of private equity's more tangible benefits to the global economy and society. Effective branding and public relations strategies have become more essential than ever.

In the face of these changing dynamics, the private equity industry continues to attract new investors and has large amounts of cash to invest. While there are divergent views on how private equity will move forward and take advantage of postrecession investment opportunities, the industry has always shown an ability to evolve with the times. But there's no doubt that this is a challenging market environment, one that demands discipline, judicious planning and innovation from private equity practitioners so that their firms and portfolio companies can emerge stronger in the wake of historic financial volatility.

In the pages that follow, we focus on a variety of practical insights that we hope will benefit investors and private equity firms alike as new regulations take hold.

**6.8%**

***The percentage of private equity investments in North American portfolios by 2012, according to a recent survey on alternative investing by Russell Investments***

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