

Alternative Viewpoint: What Next for Private Equity?

Following a turbulent 12 months for the industry, six experts from across the private equity spectrum explore the shape of things to come.

After seeming to achieve eye-popping returns year after year, the U.S. private equity industry stumbled in 2008 (like almost every other sector of the financial services industry). Returns were nearly 30% lower than they had been in 2007. And the news in 2009 hasn't been much better – in the first six months of the year, only \$24 billion worth of private equity deals were completed (globally). In 2008, the equivalent figure was \$131 billion. In 2007, it was an astonishing \$528 billion.

These developments have been a catalyst for private equity firms to adopt new methods. They are taking on less leverage and

assuming less risk. That's to be expected, given recent events. But peering further into the future, the largest private equity firms have \$400 billion worth of debt maturing over the next five years. In an environment marked by less risk, less leverage, and thus the likelihood of lower returns, how difficult will it be for these firms, and their smaller brethren, to settle their accounts?

That is one of many unanswered questions about private equity. For an informed perspective on emerging trends that could be shaping the industry's future, the *FTI Journal* asked six experts to offer up their thoughts about where private equity goes next. Edited excerpts of their responses follow.



THE PRINCIPAL JEREMY COLLER

It is inevitable that the private equity industry will be successful. To understand its true potential, you need to put the buyout boom years and the current market difficulties to one side and consider the bigger picture.

Look at the changes to the investment landscape over the last 150 years. The mid 19th century marked the beginning of the modern concept of the limited company. Whereas previously these needed to be created by an Act of Parliament, the UK's system of incorporating a company through a simple registration procedure, introduced in 1844, was rapidly copied throughout the world. Despite this, ownership was limited to private wealthy individuals.

The creation of large aggregation vehicles such as pension funds in the 1950s and 1960s marked the beginning of institutions holding shares for the benefit of policyholders and investors. In the 1970s these

institutions became the majority owners of large public companies. Consider the amount of capital held by insurance companies, corporate pension plans and state-controlled pension funds, and the fact that until comparatively recently these entities could only invest in equity through the public markets.

The private equity industry started on a very small scale but in the mid 1990s there was a massive explosion of money chasing private equity. The industry will continue to grow over the coming decades before reaching equilibrium at a much higher level than it is today. Of course, the market for private equity is cyclical like any other, so there will be peaks and troughs like the ones we have experienced over the last few years. But over a longer period we will see growth.

The rise of private equity secondaries is also inevitable. It's true that growth of the secondaries market is a natural consequence of the current liquidity shortage, but that is far from the whole story. For a long time, investing in private equity was a

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game of buy and hold. The secondaries market provides a way out for investors that will become increasingly attractive.

The dynamics of private equity investing have changed enormously since the onset of the credit crunch, but the make-up of investors' private equity portfolios largely reflects pre-credit crunch conditions. Many investors – even those not facing liquidity issues – will consider selling assets in the secondaries market simply to help them reshape their portfolios in the light of new economic realities.

Momentum in the secondaries market will pick up during 2010 as private equity valuations become more realistic and the volatility of financial markets reduces. In addition, the re-starting of investment in the primary market will result in a flurry of capital calls creating acute liquidity needs for many investors. We will also see some institutions come under pressure from CIOs or trustees to sell private equity assets in order to adhere to their funds' asset allocation policies.

Finally, you will start to see a much bigger difference between the returns generated by the best- and worst-performing managers in industry. For many years, investors were able to throw money at the private equity industry almost indiscriminately and achieve incredible returns. Everyone made money. Now the skill a general partner brings to the table is incredibly important, and you will see more investors looking to switch horses before a fund is fully realized.

Jeremy Collier is the founder and CEO of Collier Capital, a leading secondaries firm with offices in New York, London and Singapore and \$8 billion under management.

THE COMMENTATOR

WILLIAM COHAN

For a window into the future of private equity, look at the recent activities of longtime market-leading firm, Kohlberg Kravis & Roberts (KKR).

The firm is close to completing a public offering of its equity by constructing a complex reverse merger with a publicly-traded European affiliate. It is also busy taking public the few successful companies in which it invested during the private equity boom of 2006 and 2007.

Even more noteworthy, over the long term, KKR is building up an investment banking business – one that has started competing with Wall Street for fees in such traditional businesses as mergers and acquisitions (M&A) advisory and debt and equity underwriting. A case in point is the upcoming initial public offering (IPO) of Dollar General, a discount retailer that KKR and Goldman Sachs bought together in July 2007 for \$7.2 billion. According to the IPO registration statement, Dollar General hopes to raise \$750 million in new equity for the company. Assuming a typical 7% IPO underwriter's fee, KKR could share in the honeypot of \$52.5 million in fees, which once upon a time would have been Wall Street's alone. KKR's new role as an underwriter now ensures that it will get some of those fees while it competes with Wall Street.

If this move into investment banking succeeds, and helps to shave third-party fees along the way, expect some of the other large private equity firms, such as Blackstone and Apollo, to follow suit. After a generation in the private equity business, firms such as KKR, Blackstone and Apollo have started branching out into investment banking to try to capture more of the fees they have paid to third parties and to create fuller, less cyclical businesses. If there is collateral damage with the large banks – in the form of taking fees from them – these firms have decided they can live with it.

Another indicator of emerging private equity trends can be found by looking at Northrop Grumman's

sale of TASC, its Virginia-based information technology business. Banks are competing heavily to finance the deal at five times cash flow. While a far cry from the eight times leverage that buyout firms could get at the recent top of the market, the deal indicates that the market for leveraged deals has reopened. Private equity investors now expect the market for leveraged loans to tiptoe back to a form of normalcy where leverage remains modest with deal terms less flexible than the ridiculous levels that prevailed at the top of the recent bubble. Practitioners view this as healthy. For instance, bank covenants, which had been all but abandoned in a fit of competitive frenzy, are starting to return to traditional levels.

But not all is rosy in private equity land. A number of the big deals constructed during the boom have imploded (see the bankruptcy filing of Reader's Digest Association, which was owned by a consortium of private equity firms led by Ripplewood Holdings). The consequences for the future? Private equity firms are

likely to see their coveted '2 and 20' compensation system – and in the case of Bain Capital, 2 and 30 – die away. Institutional investors are also cutting way back on their fund commitments, which means the days of \$10-billion plus funds could be over as well.

It is clear that the private equity industry won't be returning any time soon to the excessive 'golden era' of yesteryear. But KKR's move into underwriting is a reminder that volatility breeds creativity and opportunity.

While private equity may be suffering from a cyclical downturn, the few rays of light now starting to emerge mean there is good reason to believe the industry will continue to loom large across the corporate landscape as a force for restructuring companies – and making money for their investors – in the United States and throughout the world.

William Cohan worked in private equity at Lazard Frères and is the author of House of Cards: A Tale of Hubris and Wretched Excess on Wall Street.





THE FINANCIAL AND TRANSACTION ADVISOR ANUJ BAHAL

The marquee private equity firms – Apollo, Blackstone, Carlyle and KKR – have emerged from the credit crisis with some bruises, but they will weather the storm. They have adapted by operating like diversified alternative investment funds; they are active in distressed debt, real estate, mezzanine financing and financial and capital advisory services in addition to traditional leveraged buyouts. They have also expanded geographically to adopt a worldwide focus. These moves position them to pursue attractive opportunities at reasonable prices. Not all private equity firms are as fortunate, especially with investment capital increasingly flowing to perceived winners.

The survival of smaller funds, which represent the majority of private equity funds in the United States, is less clear given the challenging business climate. The firms which survive and thrive will be those that recognize today's LBO market is less about leverage and more about generating and implementing smart ideas and strategies and defending and creating value from operating decisions at portfolio companies.

In the near term, private equity firms of all sizes will continue to actively nurture portfolio investments in order to ensure preservation and future growth of equity value and to meet the challenges of refinancing maturing debt on workable terms over the next few years. But the real challenge for sponsors will be generating sustainable top-line growth and improved working capital at portfolio companies, because much of the easiest cost-cutting has already been carried out. Fund managers will also be looking to

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make opportunistically priced tuck-in acquisitions to complement their existing operations and drive scale.

Given the vast amounts of capital at the disposal of private equity firms, look for them to invest in areas where capital is sorely needed: the banking, real estate and mortgage industries. One potential obstacle, though, will be formidable regulatory and execution hurdles.

Private equity firms are also likely to pursue more minority interest investments and private placements in public entities (so-called 'PIPEs') – more than 50 U.S. deals involving \$14 billion of capital have already been done in the last 18 months. And there has already been an acceleration of private equity activity in distressed M&A. About \$80 billion of distressed debt deals have been done in 2009, and more may be on the way, given the onerous debt maturities on the horizon. Regardless of what happens, traditional buyouts will eventually return, but initially they will be smaller deals with lower thresholds on internal rates of return, less reliant on leverage and heavily dependent on more conservative forecasting and financing than in prior years.

History reminds us that some of the best private equity fund vintages were created amid adverse conditions akin to what we are experiencing today. This asset class is here to stay – it will evolve and adapt as necessary to meet the challenges and seize the opportunities that cyclical industries inevitably encounter.

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THE INDUSTRY VOICE

JAVIER ECHARRI

The private equity model has a huge amount to offer the future of the world's economies. First, look at the industry's relative size. Private equity is less than 2% the size of public equity by most measures, and in Europe accounts for just 0.4% of GDP. This suggests there are many more opportunities across the economy that would benefit from private equity's style of ownership.

Second, private equity has demonstrated its resilience and ability to withstand extreme market and financial conditions, and to steward businesses in a responsible and supportive way through thick and thin. This helpful stabilizing effect in the economy should be recognized as regulators around the world pay more attention to systemic risks. The collapse of the credit bubble destroyed many parts of the financial economy. It also eviscerated the private equity market and in some cases forced managers at the larger end to reassess tactics. Given that private equity invests in real businesses, there will inevitably be some failures. But the underlying value creation strategy of private equity investment was never reliant on abundant credit or rising markets. It is about focused and committed company ownership. This remains an enduring quality.

Third, we are entering an era when political and social emphasis will be put on long-term rewards based on building sustainable value. In this area, private equity is an exemplar. Its

long-term remuneration structures and alignment of interest between investors, managers, company executives and, very often, the workforce, are a vital element of its success. The future of remuneration across the corporate and financial sector is destined to follow the lead set by private equity, as social, political and regulatory pressure is exerted on short-term profiteering.

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THE IN-HOUSE COUNSEL DAVID SPURIA

Private equity has traditionally been a lightly regulated industry in the United States. That may be about to change, as Washington looks to overhaul regulation of the financial sector. The implications could be far-reaching for private equity firms, their investors and the broader economy.

Three reforms are looming on the regulatory landscape. First, there is an effort underway to increase taxes on private equity firms. Under current law, investments made by private equity funds are treated as capital assets, and the general partner's carried interest share of the net gains is taxed on a 'pass-through' basis as capital gain. That translates to a tax rate of 15%. But the Obama Administration is expected to support congressional efforts to strip carried interest of its status as a long-term capital gain, and thus treat it as ordinary income. And that translates to a federal tax closer to 40%. The impact? Less capital for private equity

firms to deploy and do what they do best: buy companies, restructure them and sell them – a process that has generated jobs and income.

The second regulatory reform proposal that's looming would change the legal status of private equity firms in ways that would alter how they operate and what they disclose to the public. One proposal in particular would alter how private equity firms are treated by the Investment Advisors Act of 1940. This law requires all investment advisors to register with the U.S. Securities and Exchange Commission, which creates significant compliance obligations related to disclosure, bookkeeping and audits.

Today, advisors with fewer than 15 clients are exempt from the law – and many private equity firms have stayed below the 15-client threshold. But as part of the financial regulatory reform package, that exemption could be scrapped. The Obama Administration has also proposed legislation that would require any entity with at least \$30 million under management to register with the SEC as an investment advisor (this would include virtually every private equity firm in existence). If enacted, these changes would bring higher compliance costs for private equity firms, as they would be required to disclose borrowing, off balance sheet exposures, counterparty

credit risk exposures, and trading and investment positions.

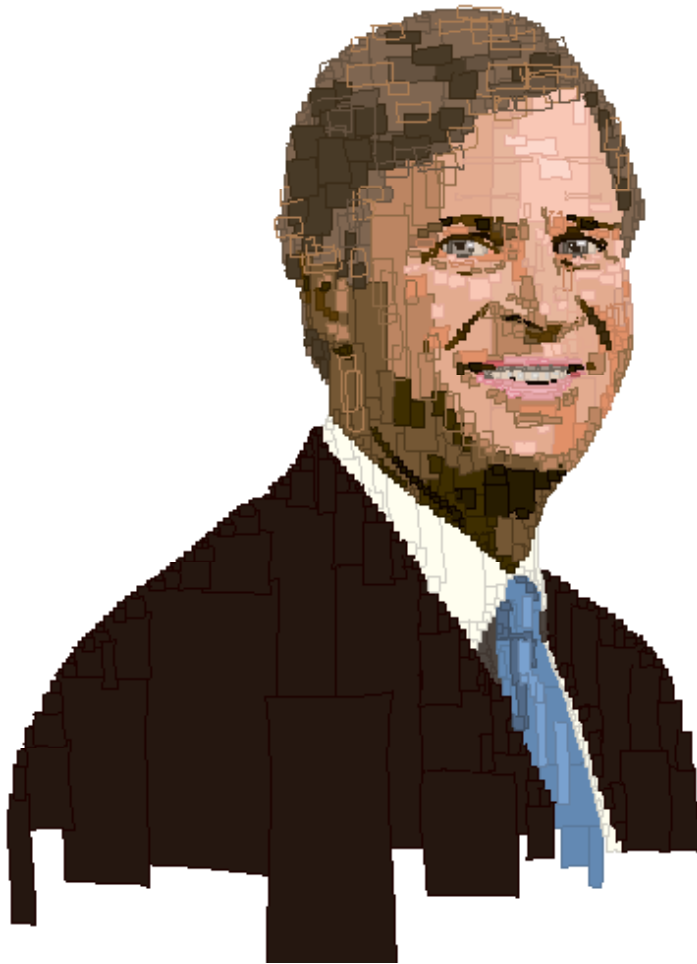
The third regulatory proposal that has private equity firms concerned is one that would place new restrictions on their contacts with their largest class of investors: state pension funds. The proposal has bubbled up in the aftermath of a controversy earlier this year involving Quadrangle, a leading private equity firm. News reports indicated that Quadrangle paid large sums to 'placement agents' to help the firm gain access to officials at state pension funds. The Carlyle Group was also ensnared, and in May it announced it would pay \$20 million as part of its settlement with the State of New York.

The use of placement agents has been common throughout the industry. But now there are moves afoot to prohibit any payments to such agents, with the SEC proposing a rule to this effect in mid-September. This has private equity firms worried, given the outsized role that capital from pension funds plays in the private equity industry. Any interference with that pipeline would inject further instability into the industry, which is still reeling from the broader market turmoil of the past two years.

Intensifying the stress on private equity firms is one non-regulatory issue: heightened tension between fund managers and their limited partners. Many firms are seeing anemic returns, and because there's so little deal activity underway, these firms are not making distributions to the LPs. Yet they are still collecting management fees – typically 2% of assets under management. This is leading some LPs to call for fund managers to reduce or suspend their fees. Some LPs are suing fund managers, and there are even instances of LPs suing each other, when capital calls aren't being met.

Some of these issues will dissipate as the economy strengthens, and new business niches will emerge. And the private equity industry's success in helping to create jobs, and wealth, will help to deflect some of the regulatory onslaught. But one thing is clear: the future is not looking as bright as the past.

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THE PRIVATE EQUITY CEO TED VIRTUE

Six months ago, everyone in the private equity marketplace was expecting the next year or two to be one of the busiest and most attractive investment periods in our lifetimes. The financial market meltdown sparked by the Lehman bankruptcy last September left every company and bank scrambling for liquidity. The \$400 billion of committed but undrawn private equity in funds looked like one of the few sources of long-term capital available outside of government intervention. Every company facing a covenant default or a maturing revolving credit, term loan or bond looked like it was going to either go bankrupt or need to turn to a private equity solution.

As companies move from survival mode to growth, private equity capital will help many companies grow organically.

To the surprise of many, the credit markets have had an unprecedented rally, opening up the primary market for over \$100 billion of new high-yield bonds and over \$1 trillion of high-grade corporate debt issuance this year to address companies' liquidity concerns. Even companies in the depressed airline, home building and retail sectors have had access to long-term debt. The equity markets have rallied over 50% from their lows, enabling companies to issue equity to delever and recapitalize. And banks have been more accommodating in providing waivers and amendments to defaulting debt, pushing leveraged capital structures forward.

With panic-selling pressure alleviated for the time being and only modest amounts of credit available for new deals, I believe private equity firms will still have two significant investment opportunities in this market environment. First is to equitize the many balance sheets that remain overleveraged from the easy money period of 2004-2007 so they can ride through the cycle. Many of these capital structures have extended their maturing debt but not deleveraged. This will be a big opportunity, especially in the absence of an economic recovery in the next 12-18 months.

The second opportunity is the need for traditional growth capital to transform companies and sectors. This has been a core strategy of private equity firms until easy money led firms to focus more on financial engineering than operating strategies. As companies move from survival mode to growth, private equity capital should be a needed source of funding for many companies and sectors to grow organically, consolidate within their industry and expand their geographic markets. Many of these deleveraging and growth investments will come in the form of minority investments, structured securities and PIPEs similar to the deals Leonard Green did for Whole Foods, BC Partners did for Office Depot, and KKR recently did for Kodak. ■

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