The New World Order of Private Equity

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As we enter 2009, the credit and equity markets remain deeply troubled, and economic activity around the world remains under severe pressure.

There is general consensus that the recovery will be measured in years and that we will see additional shocks, more fallout and new lows before global growth returns. Not surprisingly, the so-called "Golden Era" of private equity investing has become a distant memory. The collapse of the financing markets, subsequent severe liquidity constraints, economic slowdown and asset deflation, along with near ubiquitous loss of investor confidence, have caused some to question the very survival of the asset class. With this sobering backdrop, it is fair to ask what the future will bring for private equity, or more specifically: what constraints will shape the practice of private equity that emerges and what factors will lead to success in the future?

Private equity has been around, even in its current form, for quite a long time. Nonetheless, the underpinnings of the industry have been badly shaken. Private equity in the new economic era will be quite different from the financial engineering that was fashionable and gave private equity its public face and a measure of notoriety. The fundamentals of private equity represent much more than just a form of financing or a leveraged bet on a bull market economy and frothy capital markets. Private equity at its core stands for an approach to ownership, governance, compensation and business transformation that has a place in the global markets and should remain a vibrant part of the economy. There are several distinguishing characteristics of private equity that will sustain its survival and mark its renewed relevance:

- Private equity at its best brought the benefits of an alignment of interests between management, employees and owners;
- The transactional nature of private equity allowed it to be both opportunistic and strategic – a transaction brings a platform for change to a business and the ability to rethink the most fundamental tenets of a business;
- Private equity creates an execution and performance driven environment; and,
- Successful private equity investing is marked by a long-term mindset with an approach of investing for the future.

In addition to these benefits, private equity fills voids in the "normal" markets for ownership and control. It will continue to play an important role when large corporations restructure and have a need to sell businesses that do not have a natural strategic home. Private equity will continue be a source of contrarian capital in out-of-favor industries. In the simplest terms, private equity relies on a supply of potential investments, the right investors to select and execute the private equity value proposition, and available equity and debt financing.

The driving forces behind the continued supply of private equity investments- mismatched perceptions of value, new CEOs and board members seeking to reshape corporate strategy and the corporate portfolio, shareholder pressure for performance, the need for an outside agent of change - will only intensify in the near future. It is hard to imagine that they will not sustain a significant level of private equity activity into the future. But this is far from saying that there will not be disruption and change, or that all firms will be able to adapt and succeed in this world.

A key challenge for LPs will be assessing the resilience of any particular private equity investment model in the dramatically different environment we are likely to face. The important questions are: Has a firm has demonstrated success in periods of tight credit, recession, defaults and macro-economic stress? How much of the firm's past performance was attributable to fair winds in the capital markets and the global economy and how much was based on sustainable profit improvements? Does the firm pursue the types of transactions that are available in tighter credit markets: complex deals requiring intensive post-acquisition operating execution? Does the manager have a record of creating tangible and quantifiable operating plans prior to acquisition outlining in detail how it will transform a business?

Looking at 2009, investment activity will ramp up gradually, with the second half of the year showing more signs of life, particularly for investment opportunities that require operating and strategic skills -- not just capital. In fact, the accelerated corporate restructuring activity that typically accompanies periods of economic weakness should produce a robust supply of divestiture and carve-out opportunities of businesses that are less strategic to their corporate parents. During the last economic downturn (1999-2001), the number of public-to-private and other buyout transactions fell 41%, while the number of corporate carve-out transactions rose 56%.

Divestiture-driven private equity activity is likely to dominate for the foreseeable future. First, global competition will continue to cause most businesses to set new priorities and restructure continuously for competitive advantage. Management teams that are reluctant or slow to make the necessary changes will fall short and will likely be greeted with more shareholder activism. The pressure to refocus the composition and direction of their businesses will lead to divestitures of non-core businesses. Second, turnover in senior corporate leadership, which continues to increase, produces changes

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in strategic direction, again resulting in portfolio restructuring and the sale of non-core subsidiaries. Over the past ten years, the performance-related turnover rate of public company CEOs has more than quadrupled. Finally, the twin shocks of a weak economy and credit crunch will likely produce opportunities to acquire subsidiaries sold as part of a de-leveraging strategy, or entire companies sold due to competitive and balance sheet pressures.

What we are less likely to see is a lot of secondary buyouts — or leveraged recapitalizations. The trading of assets was facilitated by debt markets that allowed a new buyer to refinance at 8 times cash flow a business that the previous owner bought with 5 or 6 times leverage. The math was powerful while it lasted, but cannot be sustained for buyouts of businesses premised on these leverage levels. For similar reasons, leveraged recaps of already highly levered companies will not be available. We should not expect many going private transactions either. Public company management and boards will find it hard to sell at depressed stock prices, unless the company is in distress. Further, the mega public to privates relied on an absolute amount of debt financing that simply does not exist today. Finally, the level of available leverage will make it harder for PE firms to pay the required premium and still generate adequate returns.

Not every private equity firm is ready to capitalize on the new world order for private equity. Inevitably some will find a significant amount of partner and professional time taken up fighting rear guard actions brought on by the tough economy. The more time spent fixing portfolio problems, the less time spent cultivating new investments and laying the groundwork for future deals.

The new era of private equity will be highly selective in terms of both the types of deals that get financed and the private equity firms with which boards and corporate management teams are willing to transact. Firms with transaction experience involving a high level of complexity and post-acquisition operating execution should have a competitive edge. Divestiture buyouts tend to require more "hands on" attention. They are typically chronic underperformers due to lack of management attention, capital and other resources needed to succeed. In difficult credit environments, lenders and investors demand investment cases that are built on tangible, quantifiable blueprints to drive operational improvements and thus substantially improve the profitability and cash flow of an acquired business. It is by definition a very bottom line and margin-focused exercise that does not put a lot of weight on sales growth projections, and hence far more suited to today's environment. Finally, reputation and credibility have never been more important. Managers who have maintained a reputation for integrity by completing the transactions they have announced and who avoided breaking deals when the credit markets collapsed should be advantaged when competing to acquire corporate divisions. Boards and management of the large corporations considering the sale of businesses will always be more inclined to work with parties that they feel they can trust and who have demonstrated the ability to close on the deal they shake hands on. The return of leveraged lending will come on a discriminating basis as well, funding deals that are sensibly constructed and investment cases based on fundamental improvement to the target business rather than financial arbitrage or leveraged growth.

If the "Golden Era" of private equity has passed, the new era of "responsible" private equity is upon us. Success will depend on the ability to mobilize capital, generate confidence among corporate sellers, and demonstrate the requisite skills to create fundamental value. The next era in private equity may be marked by fewer and smaller transactions, but in all likelihood will feature a higher quality and more sustainable set of transactions. Private equity is destined to survive, but its most prominent feature going forward will be the improved management and operations of the companies that come under its ownership.

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