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MARKET OVERVIEW

The highs and lows of private equity

BY CLAIRE SPENCER AND MARK WILLIAMS

Over the last 18 months the volume of buyouts has broken records. In 2006, buyouts reached $737.4bn globally, more than double the previous high of $352.3bn in 2005, according to Dealogic. Private equity accounted for 18 percent of total M&A, up from 12 percent in 2005. In the first half of 2007, the value of announced deals soared to $630.9bn and accounted for 22 percent of total M&A. These figures were propelled by the $43.8bn offer for TXU, which was soon eclipsed by the largest buyout on record: BCE for $48.5bn. Private equity firms have routinely outbid strategic buyers and more often competed among themselves for assets at auction.

But in a short space of time, the playing field has changed. Credit markets have frozen as banks and investors have become reluctant to participate in the highly leveraged deals they were throwing capital at until July. Add to this the increased scrutiny of private equity in the past year, hauled out of the shadows by the media and government, and it has been an eventful period in the industry's history.

As deal figures climbed and liquidity flooded the financial markets, concern mounted over the risk and fragility that private equity brought to the system. But according to Mounir Guen, the founder and chief executive of MVision, there is a misconception circulating: that private equity firms have pushed for dangerously high levels of leverage over the last 18 months. "Make no mistake, the investment banks have been the creative force behind the recent buyout boom. It's not general partners outbidding each other and squeezing investment banks that has driven deals, so much as the investment banks coming up with new ways to outbid each other and provide more debt to private equity firms. Buyout houses use disciplined investment models when assessing the burden of debt on a company but they need to exercise caution given that financing structures are so creative and fluid, and valuations are higher."

More leverage does increase the risk on individual deals and put the self-correcting mechanisms of private equity under pressure. While it is rare for private equity backed companies to default on their debt, many have very little room to manoeuvre, leaving them vulnerable to financial setbacks. A KPMG survey released in February 2007 revealed that 74 percent of corporate and 83 percent of private equity respondents saw over-leveraging as a major concern. But only 3 and 4 percent respectively believed the situation would lead to a crisis. Recent developments may have altered their opinions since refinancings may be harder to complete in the months ahead. Still, supporters of the private equity industry point to seasoned professionals who understand the risks from the outset and structure their deals accordingly. They expect portfolio company insolvencies to be intermittent rather than widespread.

The freeze in the debt syndication market began to take hold in July 2007. KKR is particularly exposed with big-ticket 'hung' deals including TXU, First Data and Alliance Boots. Volatility also meant DaimlerChrysler had to borrow around $1.5bn to help Cerberus take control of Chrysler, after the banks lowered their debt commitment. Yet many market observes believe that although investment banks are having trouble syndicating leveraged debt to investors, the backlog will eventually work its way through the system. It is, however, likely to create a slowdown in the pace of buyout activity in the months ahead. "The volume of transactions has declined recently and I see no reason for that to change in the short term," says James R. Tanenbaum, a partner at Morrison & Foerster LLP. "Moreover, private equity firms, having recognised that they will need to think differently about leverage, will find themselves outbid by strategic buyers with greater frequency than even six months ago."

That is not to say that private equity is set to fade out; financial markets are cyclical and downturns are inevitable. Returns may be lower if more equity needs to be put into deals and financing becomes more expensive, but the private equity model remains compelling. Some private equity players actually welcome the market correction, arguing that it should bring valuations down and improve returns. Going forward, although average deal sizes are likely to get smaller, opportunities will be available to those who downsize their target focus. Mega deals should occur sporadically instead of regularly. "While the market may be coming off of a peak, there is still plenty of money to be made on the plateau," says Mr Tanenbaum. "Huge private equity transactions are likely to continue, albeit with less frequency. If the level of activity continues to decline for long enough, it may actually cause deal prices to become better aligned with historic norms. That has always gotten the attention of both private equity and strategic buyers," he says. Those predicting the end of the mega deal may be premature in their assumptions. These deals occur not only because more debt is available but also out of necessity. Inefficiency is rife at many at multi-billion dollar companies and private equity can provide the viable solution of operational improvement. But problems may arise when it is time to exit companies bought at high valuations, which could result in holding periods above the norm in coming years.

This year the private equity industry has also been forced to grapple with the spectre of increased regulation and tax reform. Perhaps the most important debate ever to face private equity centres on whether carried interest should be taxed as capital gains or ordinary income. This issue has been most prominent in the US and the UK, where carried interest is currently taxed as capital gains (at 15 percent in the US and 10 percent in the UK) rather than ordinary income (at 35 and 40 percent respectively). Any reclassification of taxes would radically alter the way private equity firms approach their investments, calculate their returns and go about their business. While management fees, which are based on the size of an individual fund, add to private equity coffers, carried interest is the lifeblood of the industry. It is the incentive that galvanises general partners through the performance improvement process to exit.

In Mr Guen's opinion, private equity should continue to benefit from existing tax treatment since anything that harms the industry will spread to the wider economy. "Private equity is a relatively small component of the corporate landscape – but it is a major catalyst. It transforms companies, creates change and drives growth. Hindering this process does a disservice to the economy and belies a lack of understanding about what private equity brings to the table. The industry should have as beneficial a tax treatment as it has to date because it is important to allow for the transformation of companies, which feeds the economy," he says.

As for broader regulation of private equity, both the UK and US governments are still in the early stages of investigation. The outcome is uncertain. In the UK, Sir David Walker has attempted to prove that the asset class can regulate itself. He has proposed a code of conduct to keep the flow of information open between private equity firms and their close constituents. One recommendation is that the asset class should fund research and data collection to aid a more in-depth understanding of the way it operates. Many private equity firms, such as Permira and 3i, have already been considering this for a number of months. In spite of these countermeasures, practitioners fear that private equity will face regulatory changes that could lead them to relocate their funds offshore where conditions are more favourable.

Part of the reason why regulatory and tax debates have intensified is the negative view of private equity which has emerged within the last year. Huge public companies have been taken off-market with great frequency. More headlines have led to more questions about this mysterious asset class and how it is able to snatch such large companies from shareholders. In the fallout, facts are distorted, complex explanations are simplified, the hype builds and in the confusion private equity is painted as a negative economic force. Of course, lavish celebrations that advertise wealth do not help. But such events give us an insight into one of the industry's main flaws: its inability to forcefully project an alternative image of itself. Private equity practitioners are used to operating out of the spotlight. Their business model is predicated on taking control of companies and being answerable only to themselves and their limited partners. Life out of the public eye has left practitioners unprepared for the rapid onset of celebrity.

A communication deficiency hampers private equity. There is a perception that it does not communicate well with the government, the media or the public. John Bellew, a partner at Webber Wentzel Bowens, believes the asset class has to be more proactive to weather the storm. "The private equity industry needs to market its positives more actively than it does at the moment. In South Africa, for example, private equity has been a major driver of successful black economic empowerment transactions, and has afforded black South Africans access to good assets. Private equity is gaining more acceptance as an asset class, although the understanding of the industry is very limited," he observes.

As private equity increases its activities in emerging markets, there will be a greater need to manage the PR angle. Activity in the last few years suggests that emerging markets factor heavily into private equity's future plans. Compared to developed markets there is less competition for emerging market deals, which keeps valuations at a more attractive level and at least partially mitigates the associated risks.

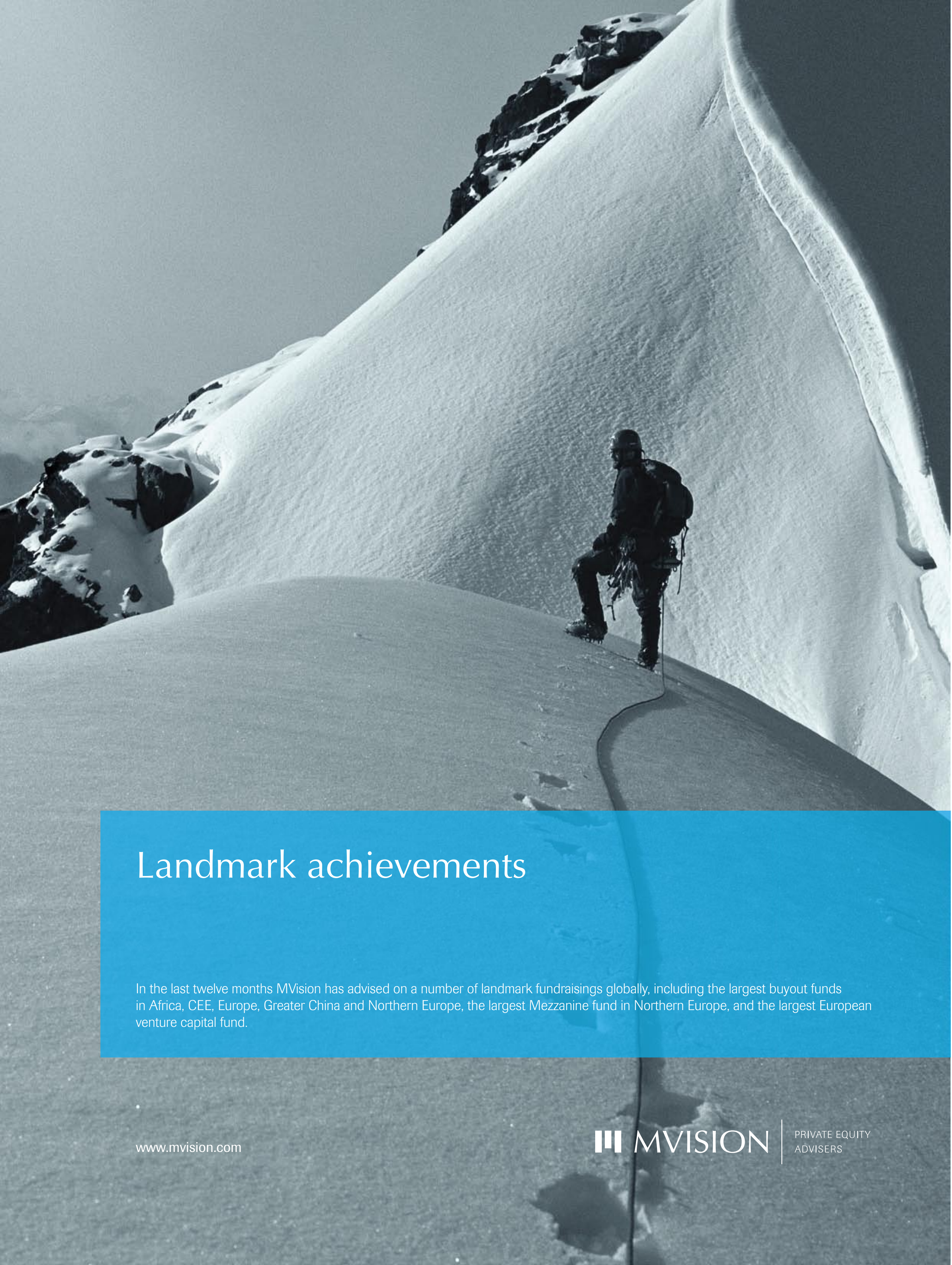
Emerging market deals are worth the risk. Although influenced by macroeconomic trends, emerging market investment can offset downturns in developed markets. Within the last month, emerging market equities remained within 1.5 percent of their record highs and the price of emerging market debt has remained relatively stable in comparison with US corporate debt. Success stories for individual deals are not confined to one or two countries either – there is money to be made across several emerging markets. "Emerging markets are very active," says Leonard A. Birmingham, a partner at Harney Westwood & Riegels LLP. "The risk/reward analysis is something that must be carefully considered but it is not an exact science. Ultimately, if the due diligence has been done, the business is properly managed and transparent, the legal risk analysed and the legal system reliable, then a large part of the risk would have been addressed."

Private equity holds a long term view, which goes a long way to explain why fundraising efforts have not dampened despite turmoil in the credit markets and the uncertainty surrounding buyouts. Blackstone recently closed the world's largest buyout fund at $21.7bn (surpassing Goldman Sachs' $20bn fund closed in April this year) and is on the verge of starting its next fundraise. Several other firms are reportedly in the mid- to late-stages of finalising mega funds of their own, including Apollo and Carlyle which have set targets of $15bn apiece. In the first seven months of this year buyout funds globally raised $139bn, putting them on track to exceed last year's $212bn total, according to Private Equity Intelligence.

Even with all this fresh capital moving into new funds, one development this year caused analysts to speculate on whether private equity had in fact 'topped out'. That event was Blackstone publicly offering shares in its management company. KKR signalled its intention to follow suit. Outsiders wondered if there might be a rush of other firms doing the same, and whether this meant it was downhill for private equity. But Leonard A. Birmingham believes the motivation is simple. "Why would an apparently very successful private equity business seek a public listing? The answer must be for the stakeholders to take advantage of what they see as a situation where values are arguably inflated – it's an opportunity for them to make more money. Whether other private equity businesses take a similar step depends on the stage of development of the business and whether they see their current values as justifying a public listing."

Public listings can bring fresh problems to private equity firms. Many industry participants question the wisdom of listing while the market is unsettled. If we are at the peak in a cycle, the growth of these companies could slow, and no prospective shareholder wants to hear that. The window may still be open for other firms to go public, but it's a very tight squeeze at best.

2007 has certainly thrown up a host of challenges for private equity. Even as buyout records were falling and mega deals seemed to pop up every week, the life of a general partner was becoming more difficult. The industry is at a crossroads. Not long ago there was little doubt the total value of deals for 2007 would rocket past 2006 figures. Now it depends on how long the financial markets stay quiet. That said, the credit crunch may be a good thing for private equity. At the very least, it brings a pause so everyone can catch their breath. A drop-off in funding should depress acquisitions and may give private equity firms a chance to focus on operational improvements at newly-bought portfolio companies, rather than chasing the next deal. When debt markets do stir again, valuations should come down. Perhaps most importantly, a dip in activity could let private equity duck out of the headlines for the first time in months. If the gaze of the media and governments drifts elsewhere, private equity may be able to restore some of the privacy to which it is accustomed. ■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