FINANCIER WORLDWIDE corporatefinanceintelligence

ROUNDTABLE

PRIVATE EQUITY OUTLOOK

Times have certainly changed in the private equity industry. Twelve months ago financial sponsors were riding a boom, closing mega deal after mega deal. Today they are reducing the size of their deals, injecting more equity to help bridge the credit shortfall and diversifying their investment strategies. So how will general partners adapt to these new conditions and continue to generate attractive returns for their limited partners?

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THE PANELLISTS

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How would you describe the private equity market over the last 12 to 18 months? What have been the underlying drivers behind the trends?

Hess: The four years prior to October 2007 saw rising valuations and a productive exit environment. The availability of plentiful debt with loose covenants before July 2007 gave market participants comfort there was some downside protection for doing new deals at seemingly high valuation multiples. Post July 2007, banks and other financing providers had to readjust their business models resulting in severely reduced availability of leveraged buyout financing. This coupled with the uncertain economic outlook has slowed deal activity dramatically. The debate today is whether one should wait another six months before doing a new deal in order to gain more clarity on the extent of the expected consumer downturn in Europe.

Checker: There has been a lot of change during the last 12 to 18 months. During the pre-credit crunch, valuations were extremely high, particularly in the industrial sector. There was a lot of available debt, equity funds had been raised and underlying target businesses were doing well. Since late summer of 2007, liquidity has dried up quickly on big deals, particularly those that were over $1bn. Industry players had hoped the market tension would end by of quarter one 2008, but that hasn't been the case. Debt availability for large deals has all but disappeared or at least not at terms that are attractive to fund acquisitions. With smaller deals, typically at much lower multiples, there has been a significant increase in the role of, and cost of mezzanine financing. Nervousness, sparked by the economic outlook and the realities of the credit markets, is resulting in less assets coming to market as valuations have dropped, so the number and size of deals has dropped dramatically. Sellers are still assuming high valuations, but buyers are assuming lower valuations as a result of the lesser ability to leverage up deals and the impact of high oil prices on the industry. The syndication of debt is also becoming more complex as primary lenders need to bring in a larger number of banks, even for midcap deals.

Allen: In relation to the global secondary private markets, the second quarter of 2007 witnessed historical high prices. However, secondary price executions declined sharply in the fourth quarter of the year. Lower prices are continuing in 2008. Drivers include institutional investors rebalancing private equity portfolios and venture funds, hedge funds and corporations liquidating legacy portfolios.

Addlestone: The rising costs of leverage and in certain cases, the absence of availability of debt finance has meant that the old private equity model of firms using leverage to enhance returns is no longer so easily available, if at all. The industry has also seen increased competition from sovereign wealth funds. SWFs are at an all time high in terms of how much capital they have available to invest. The industry is at that point in the cycle where SWFs are in a great position to invest but private equity is struggling to use its traditional model.

Guen: Although the market has been slow in the US and patchy in Europe besides the Nordic region, the emerging markets have thrown up a wealth of opportunity. For example, the emerging market pipelines for general partners are buzzing with activity, with funds being distributed at unimaginable rates.

Gumina: Private equity has had a rollercoaster ride over the last 12 or 18 months. After high leverage during the first phase of the period, then a low spot in the third and fourth quarters of 2007, we are now seeing more lenders coming back into the marketplace which is obviously a positive sign for everyone in finance, not just private equity. Private equity firms that have the right approach, the right focus, the right strategic vision and the right creativity are going to be successful just like they were going to be successful two years ago. The change in the economic cycle has just put more emphasis on the creativity and the investment judgement in private equity as opposed to a race for who can come up with the most leverage the quickest.

Youle: Since last the subprime crash, the industry has had to refocus on the fundamentals, for example, searching for high calibre management teams and assets where the financial model is stable and can be sustained. If the base case fundamentals are right, there are still deals to be done. However, with fewer deals being done, private equity houses are spending more and more time with their portfolio companies.

O'Neill: Having experienced tremendous growth in funds raised and deals completed in the last several years, private equity – a sector that 'grew up' away from the scrutiny of the public markets – is now a high profile player in the US economy. Its very success has made the sector more vulnerable to criticism. Private equity is just beginning to tell its story.

Have any notable acquisitions or recent failures caught your attention. Why?

Addlestone: The Carlyle Group recently closed a $1.4bn fund to buy distressed debt. This is seen as a move to take advantage of bargain basement prices caused by the credit crunch, as banks attempt to dispose of their debt to restore balance sheets. TPG, together with Apollo, Blackstone and others are also reportedly putting together a deal with Citigroup to snap up $12bn worth of Citi's leveraged loans. These transactions indicate the new opportunities for private equity and that despite the credit crunch, private equity still has significant capital to work with. As for failures, M&A is the hardest hit sector. Some $11bn worth of deals were cancelled in January alone. The $9bn takeover of Australian explosives maker Orica by a consortium of Blackstone and others was a recent casualty. The main cause has been the lack of available credit. Financial sector deals have also been hard it. Kaupthing cancelled its acquisition of NIBC, the Dutch investment bank. In addition, SWFs keep coming up against regulatory barriers as governments seek to block or restrict investment in their domestic strategic industries.

Guen: The EMI deal definitely catches the attention as the GP is going out of his way to follow the Walker guidelines making himself openly responsible. The deal itself is incredibly complex and many challenges are yet to arise. Another point is the interesting trends in the emerging markets where deals are becoming a lot more influence and control oriented.

Checker: Last year, SABIC of Saudi Arabia purchased General Electric's $6.5bn global engineering plastics business (GEP) for around $11.6bn in a deal that highlights the premium value of a strategic buyer over that of private equity. For SABIC, the acquisition premium was justified by the long term value, to the region, of GEP's people and expertise as well as the desire to broaden and balance its petrochemicals portfolio and develop the region's ▸▸

downstream industries. Several deal timelines have been sidetracked as buyers have walked away or restarted discussions on value adjustments.

Allen: Concerns in 2008 include LBO fund asset write downs, small to mid-sized venture funds entering wind-down mode and funds extending their terms as exits decline due to slower economic growth. In particular, LBO portfolio company debt defaults are becoming a major risk in 2008. For example, in the first quarter of 2008, Sun Capital Partners reported that three portfolio companies filed for Chapter 11 – Wickes Furniture Co., Sharper Image Corp. and Lillian Vernon Corp. Secondary acquisitions are getting done due to venture, private equity and hedge funds utilising the secondary private markets as a source of deal flow and the arrival of publicly traded entities as new providers of liquidity.

Hess: In the US, there have been a number of large scale buyouts announced that have so far failed to complete. A common feature of these is their large size and announcement just before or at the inflection point of the credit crunch. We are now starting to see some initial Chapter 11 plans for certain US portfolio companies.

Youle: In the UK, the Biffa take private was significant in the current climate given that private equity transactions of more than £1bn are becoming increasingly rare. Biffa's business model makes it attractive for investment. It has got resilient infrastructure type qualities. It will be interesting to observe the debt syndication process given that it was the Boots syndication that stoked the credit crunch issues last summer. On the flip side there is the Clear Channel deal, with the trial against six banks. The banks are accused of attaching unduly onerous conditions to loans, which have made it impossible for the private equity firms to proceed with the buyout of the media company agreed 18 months ago. If the banks are successful in defending the claims, there will be implications for more buyouts agreed before the credit crunch started biting.

O'Neill: Any completed deals above $1bn in size are notable in the current environment. There were several deals announced in 2007 that were not completed, and this was due to the credit crunch and the subsequent lack of available debt. LBO deal volume in the first quarter of 2008 was down 20 percent, and those that were done have found non-traditional sources of debt.

Gumina: Private equity players have been creative in terms of alternative ways to finance transactions whether that be customers or other types of strategic investor that will come in alongside private equity. Clearly, a concerning trend is the way that lenders and private equity funds are locked in litigation against one another.

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CHRISTIAN HESS

Do you expect to see private equity move away from deals in mature markets to focus on the emerging markets? What are the driving factors behind this?

O'Neill: Private equity investors are always looking for 'alpha' and will look for deals in any market that will help them achieve the above average returns they seek. They are attracted to markets where there is an availability of companies with extraordinary growth potential and emerging economies are no exception. Deals in emerging markets tend to be smaller, minority investments that are less reliant on the credit markets. These are more likely to better weather the current market cycle.

Youle: There is definitely an increased focus on the emerging markets. For funds that are geographically focused in these markets, local debt – which remains largely unaffected by the London and New York inter bank lending markets – can be raised. There are good deals to be done in these markets, with stability and certainty as the driving factors.

Guen: Many emerging market countries have addressed a number of inefficiencies and have very decent growth potential within various sectors and regions. The name of the game for the next five years is responsible ownership with operational inclination in growth opportunities.

Gumina: There are still opportunities within mature markets, however, private equity is clearly looking for new opportunities to invest capital at attractive yields and that could be emerging markets or emerging sectors. Private equity has historically demonstrated an ability to attract strong talent and to build a strong presence in geographies and in sectors. Going forward, there will be two distinct structures. Big funds will fully establish an even more global presence and will be important to generating attractive investment opportunities over the next five to ten years. Small geography or sector focused funds will also become more prominent. Limited partners tend to like that specificity or that particular sector focus among some of the smaller funds. In either case, local geographic presence or sector focus is key to building relationships and generating the best deal flow.

Addlestone: Some of the top 50 private equity houses have already or are in the process of opening offices in emerging markets. For example, Carlyle and Cerberus have each opened offices in Dubai to facilitate raising of capital and source deals in the emerging markets. We are seeing forecast high growth rates in countries such as China, India, the Middle East of somewhere between 8-10 percent whereas the US is showing forecast growth of merely 1-2 percent at best. Emerging markets have been less affected by the credit crunch and do not face the same challenges as exist in some of the more mature markets — it is still relatively easy to obtain debt finance without incurring prohibitively high costs.

Hess: Private equity firms have been investing in the emerging markets for a number of years, but at an accelerated pace over the past two. Many bigger private equity firms have opened offices in Asia. We are now also seeing a number of upper mid-market firms starting to do the same. The rationale is to assist existing portfolio companies to tap into the highest growth region in the world and identify new private equity deals that might include majority or minority stakes. Growth, both top line and bottom line, is at a premium to drive equity returns in an investment environment with limited debt availability.

Checker: We do not expect to see deals move away at the expense of other regions because many of the firms have raised funds that are either US or European focused, so they are obliged to invest largely in firms domiciled in those regions. In the last two to three years, they have been raising new funds that are focused in Asia. Asia is a growing market; early entrants are generally rewarded if they find undervalued assets, often run by less experienced business operators that can benefit from financial firms, with global reach to support growth. The overall diversification of the private equity firms fund portfolio is also a plus. The downside is that the deals tend to be smaller and more complex due to legal and cultural challenges.

Which regions will be of most interest to private equity, and why?

Gumina: Asia will be of most interest to private equity given the economic expansion within the region due to population growth and social dynamics. For example, the social dynamics in India and China indicate there is a greater demand for better healthcare, retail and consumer projects and technology. In addition, Brazil is emerging as a particularly attractive market given the economic growth and recent investment grade rating. Although demand is creating opportunities in these geographies, it is important to remember that the risks in each country are different. Having individuals locally that thoroughly understand those risks, how to deal with those risks and how to value or price those risks is essential.

O'Neill: China and India continue to be of significant interest to private equity investors. At the end of 2007, there were about 500 private equity firms investing or about to invest in India, with mid-market firms representing more than 80 percent of this group. In China, the economy is growing at an explosive rate, providing considerable opportunities for investors. However, Chinese authorities appear to be working to dampen the pace of foreign investment, and not only encourage local private equity firms to compete with foreign funds, but they also apply regulations to block deals originating offshore. There has also been a notable uptick in private equity in Latin America. The primary source of private equity activity in Latin America continues to be the US and Europe, but recently more deals have been sourced within Latin America itself. Factors leading to this increase in private equity activity in Latin America include liquidity, economic growth, uncertainty in the US market and local currency appreciation against the dollar.

Guen: The region of most interest is China. One month feels like one year in terms of structural evolution. If you go back to China a year from now it would literally be like a decade has gone by in terms of infrastructure, governance, models, and executions – showing the dramatic rate of change. Mainland Europe is still proving popular for private equity, with US investors focusing on small - to mid-cap strategies.

Addlestone: Regions such as Brazil, Russia, India, China (BRIC), Middle East, Africa and Asia are right up there. They are less affected by the credit crunch and so private equity can still borrow at attractive rates to leverage their investments. BRIC markets are high growth rate economies. Southern and Eastern Europe is also attracting much interest due to strongly growing economies and the relative ease of sourcing bank debt for these markets. Although the inherent risks include political meddling, currency volatility and fraud, I do not believe this will put off firms from investing. I also expect private equity to keep moving into Eastern Europe and further eastwards.

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RICHARD ADDLESTONE

Youle: Attractive regions are Asia, CEE, Africa and South America, where the playing field is not as competitive. Good assets are available in stable industry sectors such as mining.

Hess: Mid-market private equity firms tend to first build out their pan-European network but are now going further eastwards. A number of the big European private equity firms are in the process of setting up in the US. In turn, the big US firms have concentrated their efforts on building out in Asia to gain a truly global footprint. In EMEA, many firms have asked their investment teams to assess to what extent they should become more active in South Africa and Russia, for example.

Checker: North America and Europe still have a large asset base that continues to undergo restructuring with companies in a continuous mode of portfolio management; this has created a natural market for private equity. Because everyone knows and follows the rules of the game, transactions occur smoothly. However, there is high competition for quality assets, and finding the right angle can be a challenge.

Allen: With regards to the secondary market, secondary market buyers are paying premium prices for performing companies headquartered in non-traditional regions in the US such as central California, Arizona, Nevada, New Mexico, Pennsylvania and the Midwest due to lower costs for employees and office space. Attractive non-US regions include Australia, Canada, Russia and the Sub-Sahara region of Africa due to their holdings in natural resources such as oil, natural gas, timber and precious metals.

As the distressed market in the West grows and private equity spreads globally, which industry sectors will prove attractive to private equity, and why?

Youle: Given the increased focus on stability and certainty, the trend will be to back natural resources, commodities and metal ▸▸

and mining services. A focus on things that are always needed and not reliant on consumer spending is the way forward.

Checker: If companies that generally have strong financials are underperforming due to external economic forces, it is reasonable to anticipate that these companies will rebound when the market cycles up. High capital intensive process industries, for example chemicals, are classic examples of cyclical performance, and with further room for consolidation, we would see such sectors remaining of high interest to private equity firms. Private equity is also taking an active role in green sectors and biofuels – these sectors offer significant upside growth but have different investment paradigms than buying and improving the cashflow of mature businesses. For example, in construction, a GDP market green construction is growing at significant double digit rates even in the distressed markets.

O'Neill: Industry sectors attractive to private equity include industrial products, infrastructure, technology, real estate, oil and gas and alternative energy. Infrastructure and technology investments provide consistent cashflow and revenue streams, which is always attractive to private equity investors. Despite the uncertainties in the real estate market, there has been a recent boom in private equity real estate funds. Interestingly, in many real estate funds, the level of back office support and compliance is often inconsistent with the billions of dollars under management. Energy, both traditional and renewables, continues to be a focus for private equity, driven by a desire to capture attractive growth opportunities.

Allen: Secondary market buyers are particularly seeking investments in the bio-fuel, agriculture, life science and natural resource sectors. However, at this time, there are significant valuation inefficiencies in these sectors, which are creating opportunities for knowledgeable investors.

Addlestone: Energy, technology, media and infrastructure are the main industry sectors that are getting the attention. Morgan Stanley has just recently announced the raising of a $4bn private equity fund to invest in infrastructure – energy, utilities and transport – where around a quarter of investments are being targeted at developing countries. Real estate is also robust. These are industries that require large capital investments and are long term holds. As banks are dumping distressed debts and securities at knock down prices, distressed debt and even just plain bank debt are also areas for investment by private equity firms either alone or by teaming up with hedge funds who are big players in this area.

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LAURENCE G. ALLEN

Hess: The industry sectors most attractive to private equity are those that show higher growth rates than others and a continued consolidation potential, either regionally or globally. I would put sectors like business services and some sub sectors of healthcare into this category.

Guen: In terms of the growing distress as it relates to private equity portfolios, there is an assumption that around 5 percent of a pool of investments will have difficulties. Due to the increasing size of private equity portfolios in mature markets, that 5 percent has become a significant volume. Relative the overall fund, the dynamic has not changed compared to previous years, but it seems like there is more distress in private equity because the scope of assets has expanded greatly. In terms of sectors, there is no one particular sector that will prove more attractive because each sector has its own kind of evolution depending on what economic dynamic it works in. But certain areas of services, consumer products, communications, technology and the entertainment business are providing opportunities. There is a shift in GPs specialising in a handful of sectors rather than targeted opportunities across the board.

Gumina: This depends on the length of perspective and the market. For example, healthcare and energy are currently two very strong sectors in the US with consumer and retail being more challenging given the economic recession and uncertainty predicted over the next 12 months. However, consumer and retail in Asia represents a significant opportunity. Being focused on the long term, whether on geography or sector, leads to the best deal flow and allows an investor to make the most informed investments.

To what extent is the global mid-market unaffected by the credit crunch? How will private equity fare in deals against strategic buyers?

Guen: Caution should be exercised in the mid-market as in the current environment I think there is still more to come from the financial sector in terms of mistakes made and restructuring experienced. The unravelling of such an environment, especially as the US is going into a slowdown will be dispersed performance – some mega funds may perform well while some mid-market funds may perform poorly and vice-versa. Investors are focusing more on the mid-market as they feel that there is less leverage and more hands-on disposition. As a result deals will be made, but strategic buyers are a little better off competing against private equity than they were before the credit crunch. For the three years prior, it was a different story as private equity firms had access to cheaper financing and were able to out-bid strategics.

Hess: The mid-market is not unaffected but somewhat less affected compared to the large-scale LBO market where it remains difficult to raise more than say $2bn to $2.5bn of funded debt. For vendors to achieve acceptable valuation levels, the credit needs to have performed well and have a strong bank following. A recent example of this is Safety-Kleen. In terms of competition, strategic buyers have the edge over private equity buyers in today's market and this is set to remain the case for the next 12 to 18 months.

Checker: There is mid-market deal making, but getting the financing syndicated is becoming a challenge, particularly in Europe. Private equity deals are not faring well. In the last two years, strategic buyers have had strong balance sheets and have funded transactions without relying on debt. They have also had strategic synergy value to help them justify a premium needed to secure these deals.

O'Neill: In the US, the majority of deals done in the first quarter of 2008 were small to mid-market transactions. Mid-market private equity firms have traditionally used regional banks for financing, and these banks have not been as exposed to the leveraged loan market. The current slowdown presents great opportunities for strategic buyers who can now compete on an equal footing with private equity for deals. Back when debt was easily accessible, private equity was willing to add leverage that was out of the comfort zone of corporate buyers. The playing field is now levelled.

Youle: The volume in the mid-market is generally down, yet private equity houses still have cash to spend and, when they decide to do so, they remain competitive against strategic buyers. There has been no real change on that front. The change is rather in the size of the equity cheque. Instead of deals being funded with 30 percent or less of equity, we are seeing the percentage equity increasing to levels of 50 percent to 100 percent.

Gumina: In my opinion, private equity is usually able to move more quickly and creatively than a strategic buyer. For example, if an owner is looking for a partner and they want to remain with the business and remain an owner of the business, and really bring in a partner for the sole purpose of growth, then private equity is the best alternative. However, in terms of pure financing, a strategic buyer that doesn't require leverage will obviously have the advantage over a private equity player.

Addlestone: The global mid-market is experiencing the affects of credit tightening but it is suffering far less than the mega-deal market. Private equity is less reliant on debt financing for mid-market deals. The credit crunch benefits those private equity houses that specialise in mid-market deals as, in competing with the large equity houses, they have developed strategies, which enable them to cope better with any lack of available credit. Being smaller, they are more specialised and have devised innovative structuring and execution of transactions in difficult circumstances.

How is the growing presence of sovereign wealth funds impacting private equity across the board?

Checker: One of the things we observed is a trend of 'teaming up'. While SWFs have different philosophies, they still want to invest in attractive opportunities. The funds bring a large source of financing to complement funding from commercial banks. On the competition front, there is very little interaction. SWFs tend to take long term strategic stakes in large, well managed companies that currently need to shore up their balance sheets, such as banks, unlike private equity who want to actively invest and support management as needed for short to medium term benefit – a different investment philosophy.

Hess: SWFs have already had a noticeable impact on the private equity scene and this will grow as they set up more private equity programmes and become increasingly comfortable with leverage. They tend not to compete head on with private equity firms in auctions, bar a few exceptions. In my experience, there has been more partnering between private equity funds and SWFs recently as opposed to head on competition.

Although SWFs have successfully adopted private equity methods and tools when doing deals, they do however manage to stir up protectionist sentiments in governments.

RICHARD YOULE

Youle: SWFs have different investment horizons – they are a different type of player. They have the flexibility to buy a broader range of assets than a traditional private equity house whether those assets are sporting institutions or typical LBO targets. Although SWFs have successfully adopted private equity methods and tools when doing deals, they do however manage to stir up protectionist sentiments in governments.

Addlestone: Private equity experiences less resistance on the regulatory side and is perceived to be less threatening than SWFs. To combat this, we are seeing SWFs invest directly into private equity funds, such as China Investment Corp investing into JC Flowers. On the flip side, SWFs and private equity also cooperate in club deals. It is also interesting to note that many private equity houses are strategically locating some of their new offices and locations in emerging markets close to SWF offices to develop working relationships. However, overall, the relationship between the two is more one of competition and rivalry than that of team players.

Gumina: Given their capital base, market knowledge and geographic presence, SWFs can be the perfect partner for leading private equity funds. A private equity fund and an SWF can establish a creative capital structure and be a very powerful combination as a partnership due to the presence, power and experience of SWFs in certain markets. As opposed to SWFs independently competing with private equity players on a regular basis, I believe we will continue to see an increase in partnerships between private equity funds and SWFs.

Allen: SWFs are making a significant impact in both the primary and secondary private markets.

O'Neill: SWFs have served for years as LPs to private equity investors and now their presence is growing into other parts of the financial services industry, following recent capital injections by a number of SWFs into US banking institutions. SWFs have co-invested with established private equity houses, and in some cases, established their own private equity operation with a full complement of staff. In a tight credit market, this new approach is injecting a welcome wave of liquidity into global financial markets.

How important are effective due diligence methods and accurate valuations? How successfully does private equity conduct such measures?

Allen: Estimating fair values for alternative assets has been challenging for GPs and LPs, and has been inconsistently reviewed by audit firms worldwide under the new international financial accounting and FASB 157 regulations implemented in November 2007. For example, in quarter one 2008, we see certain large market buyout funds estimating current values at cost for holdings acquired in 2006, although it seems clear to us that price to EBITDA multiples for large private companies in many sectors have declined 20 percent or more.

Hess: Due diligence has always been important but has become even more so in a lower growth and therefore longer average hold period environment. The key debate at private equity investment committees is the relationship between entry and exit multiple. In the past this was often assumed to be identical, however since the summer of 2007 the question has been whether the exit multiple should be 1, 2 or more EBITDA turns lower than the entry multiple. Private equity firms are also increasingly stress testing their 'base case' to reflect an expectation of higher inflation and a slowing economy. Private equity firms are very conscious that LPs will increasingly undertake their own due diligence on each private equity firm on how professionally and thoughtfully they operate in this area.

Youle: I have always had the view that the private equity approach to diligence is more successful than other methods used in the market – for example, the partner-led adviser teams and the focus on red flag and value issues. It has always been critical to get the cashflows right, with care in both forward and backward looking diligence to confirm assumptions and whether there is anything that could jeopardise the financial model. Valuations have always been key and accurate ones in this market are even more vital. I read recently about a private equity house that looked at a deal pre-credit crunch, where the blended cost of the debt package was 300 bp over EURIBOR. Today it's 600 bp over. At a 4:1 leverage ratio, the extra cost of debt means the price of acquiring the company would need to go down by around 30 percent in order to achieve the same return on equity.

O'Neill: Conducting due diligence and reaching the right price have never been more critical than in today's market. Now that cheap debt is no longer available, private equity investors will not pay a price that does not allow them to achieve their hurdle rate of return. They are patient and putting significant effort into working their financial models and forecasting return rates. Private equity players are disciplined and will walk away from a transaction if their hurdle rate cannot be met. To gain competitive advantage and to mitigate risk, buyers should involve advisers early in a transaction to provide due diligence insight and not get locked into the deal at a time when they have less knowledge than the seller.

Gumina: Clearly having an effective, well-functioning due diligence process is critical to making good investment judgements. The key to effective due diligence is to identify the core issues and run those issues aground in a detailed manner as early in a process as possible. This obviously allows more time for focusing on the tactics of actually winning the deal. Firms that are focused on a particular sector can move more quickly in due diligence processes and differentiate themselves not only on price but also on speed, understanding and the ability to be a good partner.

Checker: Effective due diligence methods are critical, particularly in time-sensitive transactions where there may be limited access to all necessary information and asset detail. However, there is a point in the process, particularly in large management carve outs, when the management team of the carve out recognises that they are going to be running the business independently and full disclosure is critical to meeting their long term financial and business objectives. Private equity is doing it successfully; when they acquire a business, they rarely have to make unusual provisions due to factors that should have been identified earlier. Using professional advisers with strong sector experience helps to smooth this process and avoid later pitfalls.

Addlestone: In emerging markets into which private equity is moving, there is a different cultural approach by vendors to due diligence — it is generally harder to perform due diligence to the usual standard applicable elsewhere. By taking short cuts on the due diligence side to win deals, private equity is exposed to more risky investments and possible reductions in returns.

Guen: Corporate governance and due diligence are absolutely crucial as are accurate valuations — even more so in a rapidly globalising world where private equity is looking to invest more in the emerging markets. When it comes, to valuing the underlying assets in a private equity portfolio, its limited partners who are pushing up the valuation. GPs prefer to be conservative and mark values down, partly to surprise investors on the upside when returns outperform expectations. But investors are reviewed quarterly and prefer the assets marked to market to demonstrate to their peers that they have made good investments.

In the current economic environment, which financing methods are proving popular for private equity firms? How are these trends different from 12 to 18 months ago, and are they set to continue?

Hess: It's less about popularity than about necessity. In today's market, you struggle to find more than \$2bn to \$2.5bn of funded debt for any one deal. The biggest change is that whereas this used to be a two to three handed deal, it now requires five to nine banks. You can imagine how resource intensive it is for private equity firms to deal with these multiple parties and as a result more and more firms have dedicated teams of private equity professionals to interface with debt providers to make this task more efficient.

Addlestone: Co-investment and club deals are popular. Private ▸▸

Corporate governance and due diligence are absolutely crucial as are accurate valuations — even more so in a rapidly globalising world where private equity is looking to invest more in the emerging markets.

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equity firms are being required to put down more equity than ever before. There has been a shift in debt equity ratios from 20 percent equity to nearer 50 percent equity. This exposes private equity to greater risks as increasing amounts of their own investors' money is being put on the line. I think this trend is due to continue until the credit crunch eases. Once liquidity comes back to the markets, there may be a steady stream of refinancings to create leveraged gains going forward.

O'Neill: When the debt market returns, the lending environment will look much more like 2004 to 2005, not 2006 to 2007. Already there are debt agreements with appropriate covenants and a move back to more expensive mezzanine debt, and away from second lien debt. Our clients are telling us that instead of making just three calls to lenders when a deal financing need arises, they now have to make 10 calls followed by extensive negotiations on covenants. Non-traditional sources of financing are also playing a larger role in the US M&A market – non-bank lenders and smaller non-US lenders are playing bigger roles in deal making. SWFs are investing in the US financial services sector and teaming up with private equity firms in joint ventures. Additional alternative sources of financing such as hedge funds, and in the US, regional banks, will increase their activity in the private equity market.

Checker: Private equity firms are getting very creative in their financing. Working with SWFs and strategic buyers has helped leverage their investment power. Partnering and looking at different financing sources is necessary to survival. One key difference is that the lending banks have more say in deals today then they did 12 months ago. There has been a clear shift in power towards the lending banks.

Guen: In the last two or three years there was a lot of innovative, inexpensive financing. It was covenant-free, there were no extra equity stakes and there was no angling to get a piece of the performance. There were innovations in creative exposures to gain volume. That has all gone, and we are back to much more traditional financing.

Youle: The methods proving popular are more equity, less debt. Instead of deals being funded with an equity cheque of 30 percent or less, we are seeing the percentage equity increasing to levels of 50 percent to 100 percent. This is likely to continue for the foreseeable future. As equity levels increase, we will see an increased focus on delivering value from operational and strategic change.

Allen: In quarter one 2008, certain private equity funds teamed up with debt funds, or their affiliated debt funds, to invest in or acquire companies in the absence of loans from capital constrained financial institutions. However, such debt has a higher cost, tougher terms and is likely to reduce future investment multiples for private equity funds. We believe this trend will continue into 2009, as financial institutions need two years to divest enough assets to significantly increase their capital adequacy ratios. Secondary buyers are likely to remain cautious and opportunistic in 2008, although secondary market transaction volume is expected to increase.

Gumina: It will be interesting to see how returns develop over the coming years based on the deals that were done in 2007 and whether covenant-lite was actually a positive or negative development for the private equity industry. Given the economic uncertainty, private equity firms are targeting lenders that understand

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JOHN O'NEILL

the company that is to be invested in and the strategy behind the investment. This way if flexible capital structures are needed during to expand the business, do acquisitions, grow the business, take advantage of dislocation in the market, they will more likely be considered. Furthermore, capital structures should give private equity credit for the fact that today deals require much more equity than last year.

To what extent are private equity firms diversifying their investment strategies in the current climate? Where are they channelling their funds?

Addlestone: Private equity is being forced to diversify and move away from the mature Western markets into the emerging markets. Moves also include reverse mergers, a focus on improving operational efficiencies within portfolio companies, for example a return by private equity to its roots, public investments in private equity (PIPEs) are on the rise as are bolt-ons where private equity firms buy smaller companies and add them to larger companies already within their portfolio. Funds are flowing into BRIC, Middle East, Africa, Asia and Eastern Europe which are seeing much attention as are industries such as infrastructure, energy, technology, media, telecoms, healthcare, distressed debt and financial companies.

Checker: Firms are looking at distressed assets and investment funds as well as a wide range of strategies that allow diversified portfolios. Funds that provide a steady income stream and exploit distressed assets are attractive.

Youle: The real trend we are seeing is private equity houses investing in minority stakes, particularly in public entities, with a view to taking control of that entity at a point in the future – perhaps when the debt market reopens for business. This does mean that hedge funds and private equity continue to increasingly occupy the same space within the capital markets – the convergence resulting from the fact that hedge funds are looking for higher returns and risk diversification, while private equity is seeking additional sources of capital and more liquid investments to generate more current returns.

O'Neill: Despite the current slowdown, private equity has a fiduciary responsibility to its LPs and will find alternative methods to put their money to work to generate returns. They are focusing on driving value at their portfolio companies, doing smaller add-on acquisitions, deals in new and emerging markets, and deals involving distressed assets. There has been a small increase in PIPEs and private equity firms have also been buying some of the backlog of leveraged loans that banks need to sell – which are currently available at a healthy discount.

Gumina: Any large private equity firm has to think about diversifying its investment strategy based on forecasts for future trends five to ten years down the line. As a result, some private equity players have launched hedge funds or real estate funds, others have launched debt or distressed debt funds to pursue returns given the dislocation in the credit markets, while others have actually purchased debt from some of the large banks that are looking to clean up their balance sheets. For long term success, the leading firms will regularly be assessing their strategies and looking for new opportunities to generate attractive returns for investors.

Guen: There is a huge amount of diversification going on, for example**,** a number of the more established private equity groups have redefined themselves as asset management firms and as a result of that are going into multi products whether it has a regional inclination or a distinction in the assets, mezzanine, debt, equity or activism areas. Although private equity is only just touching on the hedge fund arena, there is certainly a move by private equity into areas of infrastructure and other aspects of debt to be able to grow assets.

Allen: We are seeing certain private equity funds seeking to diversify their sources of revenue. Some LBO funds are developing in-house capital markets groups to raise private capital and create exits for portfolio companies and are also seeking to partner with independent portfolio managers that specialise in natural resources, energy and international sectors. Some buyout funds are pursuing mezzanine strategies. Certain venture funds are typically revising their business models to create more critical mass by offering new funds in real estate, international and private equity sectors.

Hess: There is on ongoing debate in many private equity firms as to whether they should expand their late stage LBO investment mandate and make their capital more 'flexible', for example, actively seeking minority investment opportunities and/or setting up distinct new investment teams for such areas as debt/mezzanine, property, infrastructure, public equity and special situations/distressed. Some firms are in the process of deciding that they want to be all things to all people and are progressing towards a full product offering, some others are sticking to what they know best.

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BUDDY GUMINA

What are your thoughts on present and future fundraising trends? Where are limited partners directing their commitments?

O'Neill: Private equity firms are still working with the capital from record breaking fundraising over the past three years, and, even now, there are 'mega' private equity players in the market raising funds. Mezzanine and distressed funds are seeing more activity. LPs, such as public pension funds, continue to want to increase allocations to the private equity asset class as well. However, 2008 will see lower fundraising levels overall. The lack of debt financing will cause private equity funds to hold on to their portfolio companies longer and do fewer deals, which in turn will slow down distributions to LPs. This will ultimately lead to a slowdown in fundraising.

Guen: In the current climate in terms of fundraising, the growth of LPs is slowing down yet the number of GPs looking to raise money is increasing. Fund managers commit to a programme, such as investing for three years and investing a certain amount each year. These days, LP re-ups tend to consume a large portion of follow-on funds and it becomes very difficult to access funds with established GPs as a new commitment. Despite this, there has been a high rate of new investors trying to enter the private equity market. In the US there is more supply than demand, in Europe there is a balance, while the emerging markets are more open to investors due to the rapid pace of investments being made.

Gumina: LPs are regularly reviewing their portfolio and making necessary adjustments based on the return opportunities in the marketplace. Fundamentally it comes down to identifying firms or organisations, in any asset class, that have a differentiated strategy and demonstrated competitive advantage that led to consistently attractive returns.

Allen: LPs are trying to rebalance private equity portfolios, typically by reducing the holdings in underperforming funds and being more selective in making capital commitments to new funds.

Hess: There is no doubt in my mind that the private equity asset class is here to stay and will continue to grow over time, even though the fundraising market will get tougher in the next 12 to 18 months. The LP community has become used to above average cash distributions from recaps/exits in the three years to October 2007 and is now looking at 12 to 18 months of very limited cash distributions given less attractive exit valuation levels in today's initial public offerings and M&A markets. LPs will scrutinise GPs in even greater detail and will look closely at their track record over the economic cycle.

Addlestone: Private equity houses are encouraging investors to provide debt and this trend to source debt in-house, rather than going to outside banks, seems to be growing. Private equity houses are looking to SWFs, pension funds and hedge funds to fill the gap in funding caused by lack of available bank debt. On smaller deals, local banks are being tapped up for debt finance.

Despite the difficulties, the top global private equity firms are making good progress in raising funds. Private equity is directing efforts at marketing their clients outside the US. As for how LPs are directing their investments; there is a shift into alternative assets.

Going forward, do you expect to see a trend in private equity working with existing portfolio companies to build and extract value? How has the credit crunch affected hold periods and exit strategies?

Gumina: There has been some press coverage recently about the rising internal focus of private equity firms on their portfolios to help portfolio companies create value. The fact is that leading private equity firms have always been focused on maximising value within the existing portfolio. Key methods for increasing value which private equity firms implement directly include management team expansion, acquisitions, expanded geographies and margin improvements. In addition, even in today's market, private equity firms continue to leverage relationships and look for attractive opportunities. They are being more creative by using different structures, reviewing different sectors and targeting different geographies. Although it is a challenge to exit in the current climate, private equity firms are constantly reviewing prospects for exit against the value of holding the investment for a period of time. Overall, I certainly expect to see fewer exits, and thereby increased hold periods, over the next 12 months given the credit market dynamics.

Checker: Most professional private equity firms have always worked closely with their portfolio companies to build value. We will see less opportunity to 'flip' businesses because there is less transaction activity, and the market valuations are going down. Long term investment is becoming more common place, and to justify premiums, it is necessary to behave more like strategic buyers – buying, building, and acquiring and actively using strong business processes to extract all of the inherent value.

O'Neill: Private equity investors are focusing on operations, and many have operational talent on staff or on retainer. In the current environment, it is crucial for private equity players to deliver maximum value from existing portfolio companies. Private equity players are increasingly looking for ways to maximise revenue growth and operational efficiencies. These strategies go beyond the widely held general perception that private equity only executes cost-cutting measures and reduces headcount. Private equity often works with management teams to address potential improvements in pricing, processes, and products. They also have the flexibility to hold assets longer if the markets are not open for exit. While IPOs have been shown to be the most profitable exit strategy, the erratic capital markets may mean more private equity players will be selling to other private equity players and strategic buyers.

Addlestone: Private equity is using this 'quiet time' to build value in the portfolio companies and is one key area on which private equity is focusing in order to keep the returns flowing. The credit crunch has pushed out hold periods as private equity is not able so easily to leverage and then flip the assets within the usual time horizons to realise the historic levels of returns on the usual time scales. As for exits, IPOs are much less attractive. Trade sales are going to be the most attractive option but even then, timely exit in this fashion may be difficult if trade buyers are hampered by lack of available credit.

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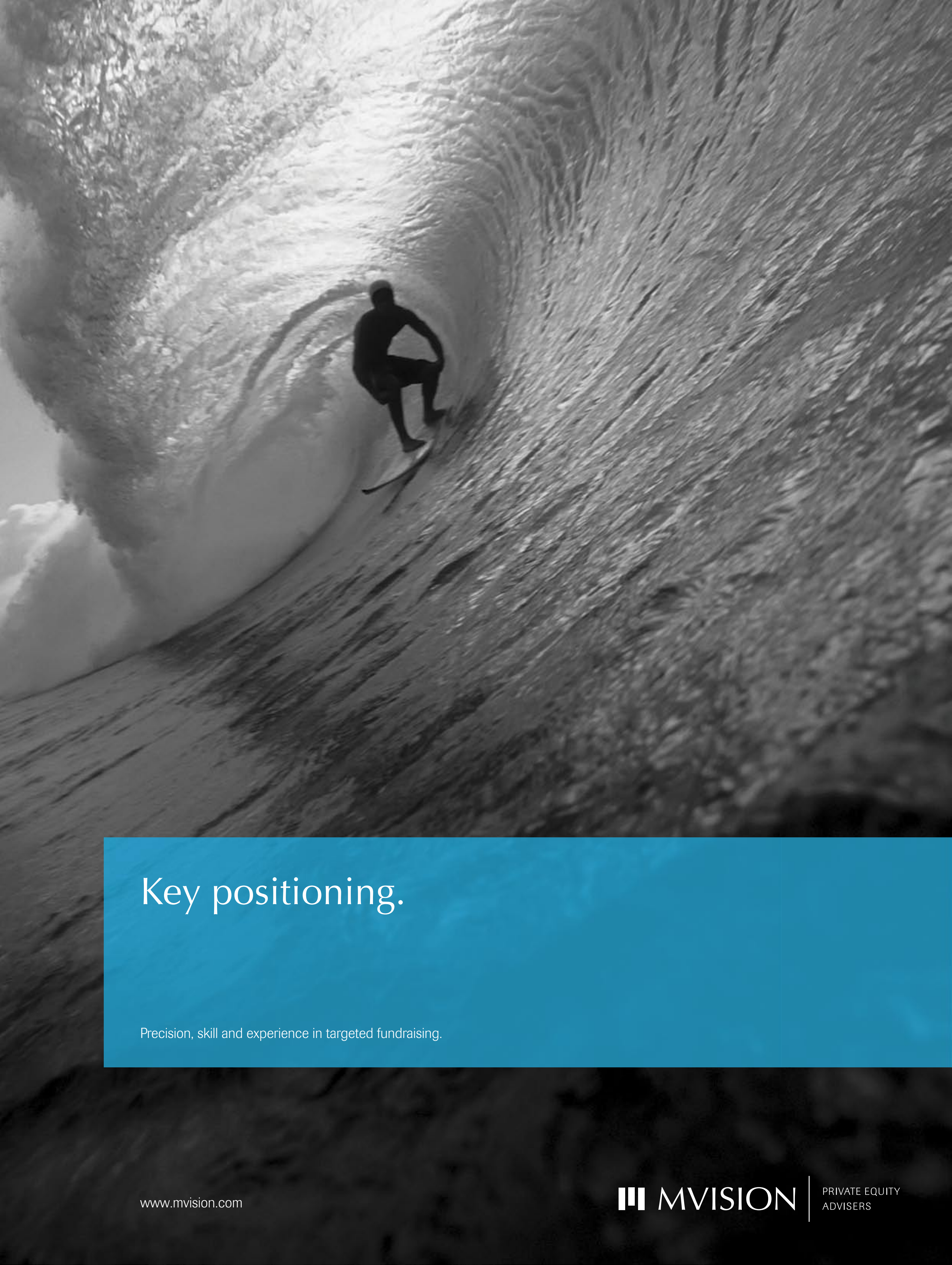
NEIL CHECKER

Guen: The type of exit strategies haven't changed much, but the timing of them and the fact that GPs are holding on a little bit longer to build a growth platform is the main effect of the credit crunch.

Hess: The good private equity managers have always worked closely with their portfolio companies to identify incremental value and to support their management teams with add-on acquisitions or optimisation of the business model – product and/or geographic focus areas. Those few firms that have banked on their returns being driven by de-leveraging of the capital structure need to become more active owners as hold periods will increase with a paucity of the IPO and M&A markets. Driving EBITDA growth will be the key focus rather than leverage or entry/exit multiple arbitrage.

Allen: The de-leveraging of the economy is causing price to EBITDA multiples to contract, thus reducing valuations, delaying exits and causing funds to extend terms. Many LPs are unsure what to do when funds extend terms, as they do not want to disturb long term GP relationships. Such LPs may wish to consider rebalancing their portfolios and divesting funds with extension risk. With a slow IPO and M&A market so far in 2008, private equity funds are increasingly generating exits via recapitalisations and sales into the secondary private markets. GPs would be wise to consider new exit strategies to avoid significant term extensions for their funds, which in general, lowers IRRs and results in lower secondary market prices.

Youle: Private equity houses are looking at their portfolio and spending more time working with what they have got. Deals will take longer to put together and private equity houses will work harder than before in putting them in place. As equity levels increase, there will be an increased focus on delivering value from operational and strategic change. It will be interesting to see what happens if and when the credit crunch eases – will valuations be driven up by private equity houses willingness to spend and do deals or will valuations be driven down by there being too many assets on the market? Only time will tell. ■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