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▶ CHALLENGES IN PRIVATE EQUITY

The last 12 months have seen unprecedented change in the private equity market. The recent deep financial restructurings and quasi-nationalisation of key global financial assets will in the near term lead to very limited liquidity, in contrast to prior years which were marked by an excess of liquidity, along with a generous dose of arrogance and overconfidence. This will put significant pressure on investments, companies and individuals that over-reached in a bull market.

This lack of liquidity will be felt globally as well as locally. The impact will spread from large to small and we will see serious portfolio challenges for the mega-funds as well as for small funds, regional funds and country funds. The natural disposition of private equity practitioners is to nurture and grow a company, so by default they are loss averse. Many general partners are therefore actually strengthening their businesses at this time with professionals and advisers to work through the difficulties of their portfolios and protect the capital of their investors – i.e., they are responsible owners. However, the threat of evaporating balance sheets looms high as companies can go from fine to terminal in weeks.

So far, emerging markets have not felt the full impact of these forces. But these problems are global, and on the present course, 2009 will see lower growth rates as commodity prices fall, in line with consumption, and the problem of Wall Street becomes the problem of Main Street, and hence the problem of the whole world. This will have a different but nonetheless negative impact in high growth markets that are dynamic and that have not relied on leverage. Pressure on management will be intense and will lead to serious challenges, and in some cases, failures.

Compounding these difficulties are new valuation policies for investors that require the GP to mark to market, which is not a true reflection of the real business plan or of corporate development. Neither is it realistic to hold investments at cost when all else is marked down 30-50 percent – so how does an investor realistically and practically assess risk and exposure in today's market?

The effect of the dynamics described implies a drop in performance for many GPs, a slowdown in cash-on-cash exits, and most importantly, a drain on resources available to salvage portfolio companies. For LPs it will be a period with less capital available as they reassess their exposures. They will have discussions with their GPs on fund size, terms and strategy deviations, possibly leading to tensions. Existing relationships will come under the same scrutiny and be put to the same test as new ones.

On the positive side, private equity is a mature and sophisticated asset class. Its practitioners – GPs and LPs alike – are highly experienced, very professional, and very responsible. For those who have cash, some of the unique opportunities available will lead to some of the best-performing vintages seen in the industry. For those who made mistakes, they will learn and come out stronger – or disappear altogether.

It will take time, but success will be there for those who work through the challenges. Change is not to be feared. Every so often it is a good thing for an industry to undergo a cleansing effect to remove an accumulation of arrogance and help investors refocus on the basics. ■

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