# Back to the future

Here, five representatives from the advisory community provide their views on what could be in store in the coming year, in terms of dealflow, fundraising, debt availability and the increasing role of the secondaries market

***Peter Hemington of BDO Stoy Hayward on deal flow over the next 12 months***

The maximum transaction size that the leveraged market can support is now significantly smaller than in recent years given the reduced number of banks and funds which are active in the market.

The return of the jumbo transaction looks unlikely in the near to medium term.

In the first half of 2009, any potential large transactions will need to be structured as clubbed take-and-hold positions by the MLA banks that still have appetite to fund new deals. There is only likely to be modest underwriting in the first six months of 2009 as there are fewer investors for the MLAs to sell the debt to than in previous years. Consequently, the mid-market segment, which has less sell down requirements, is likely to see the most activity.

Relationships have always been important, particularly in the mid-market, but they will become key over the next few years. I suggest those banks that are operating in the leveraged finance arena in 2009 – and there is little doubt that this will be a relatively small group compared to the first half of 2008 – are likely to be very focused on where they allocate their capital. If they are approached by a sponsor with a potential deal opportunity in 2009, banks may not just be assessing the relative merits, or otherwise, of the prospective deal. They will be asking themselves: how well do we know the private equity house; what have they shown us in the past; and what is their track record?

Embedded relationships will also become increasingly vital as, until now, it has always been incumbent on a bank to develop the relationship with a target private equity house in a particular sub section of the leveraged finance market. However, sponsors should now be asking themselves how well they really know their core banks and the extent to which these relationships are established through all levels of their teams. Sponsors that are relatively detached from their banks could find it more of a challenge to gain access to a limited supply of bank debt.

***Bernhard Engelien, director at Cogent Partners, on the developments and growth potential in the secondaries market***

2008 has seen an unprecedented level of activity in the secondaries market for private equity fund interests. Cogent estimates that the global volume of transactions increased from $20bn in 2007 to $30-35bn in 2008. The year has also seen the return of distressed sellers, following a three-year period where most transactions were driven by portfolio management considerations aimed at rebalancing portfolios or reducing administrative burden. These developments combined with the seizing up of debt markets, sharp correction of stock markets, and worsening economic outlook have led to a significant decline in secondary market pricing. Average high bids on transactions advised by Cogent declined from 104% of NAV in 2007, to 85% in the first half and 61% in the second half of 2008.

The market is likely to continue to grow in 2009, driven by the need for many LPs to further reduce their exposure to private equity following the decline in other liquid assets classes such as public equities (the 'denominator effect'), as well as by short-term liquidity needs. This rebalancing will be supported by the publication of funds' year-end NAVs, which are broadly expected to show a 20-30% decline.

Another important factor which will influence growth is the amount of available financial and human capital among the buyer community. At the moment, supply outstrips demands as a large share of the approximately $40-50bn of buy-side capital still needs to be raised, while the recent wave of layoffs among banks and private equity firms represents an opportunity to bolster buyers' investment teams.

This leads to the question of what will happen to pricing, which will be impacted by three factors. Firstly, how aggressively will GPs mark down their portfolios at year end? Secondly, how will the recession impact portfolio companies' performance? And finally, will market volatility abate and valuations stabilise somewhat?

***Simon Tilley, head of the European financial sponsors group at Close Brothers Corporate Finance, on the major challenges and opportunities facing the market***

Making predictions for the year ahead against the backdrop of such harsh and unpredictable market conditions is a dangerous game. There is no question that 2009 will be another challenging year for private equity, even more so than 2008. The global economic slump will be deeper and more prolonged than many anticipate and, despite the best efforts of central banks and policy-makers, the illiquidity that currently characterises both the debt and equity capital markets will persist.

Corporate trading performance has started to come under pressure with the "sticking plaster" solutions to balance sheet issues that we saw in late 2007 and early 2008 giving way to more fundamental restructurings. This trend will intensify as corporate profitability and liquidity comes under further pressure. Management teams, lenders and other stakeholders will look to the private equity community for solutions. However, this will not be easy given relative valuations and the strong likelihood that things will get more difficult before they improve.

But there will be glimmers of hope, most notably in the mid-market. Growth capital deals, non-core disposals and distressed M&A opportunities will all be on the agenda in 2009. We may even see one or two of the much vaunted public-to-private deals taking place. Cashflow lending will see some pick-up in activity although multiples will remain conservative as "self-syndicated" club deals replace the "spray and pray" approach to institutional syndications of the pre-credit crunch era. It is also likely that asset-based lending will start to be embraced by private equity.

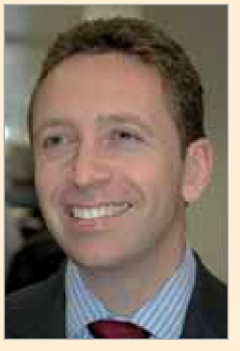
Survival of the fittest will be one of the key themes for 2009. Recent talk has been of LP defaults and if the macro environment plays out in the way many expect, this will be a major issue in 2009. More than ever, track record will be absolutely critical.

**Andrew Lynn, director in Hawkpoint's debt advisory practice, on the debt markets and the availability of financing**

Few are expecting any rapid change in the debt markets in the New Year. Even those with available capital and budgets will start the year cautiously and take time to understand the new market and, perhaps more importantly, the state of economy. Any lender who has been active in the past three years will have a significant task managing their portfolio and a lot of resource is already being reallocated to previously scant work-out teams, many of which are facing a steep restructuring learning curve. The advisory community is already engaged in many of these processes and restructuring is expected to form a significant part of activity.

For the deals that do raise new money, clubs will continue to be the norm. However, the impracticalities of this approach will eventually drive testing of when underwriting might again be possible, with some very small scale underwrites being used as test cases as the year progresses. Greater liquidity is needed in the secondary market to ensure that prices are reflecting the genuine credit risk. Right now, with investors waiting to call the bottom of the market and banks reluctant to reflect the write-downs ahead of next year's reporting season, the opportunity cost of secondary prices remains a stick to use in negotiations with borrowers.

At the smaller end of the market, the clearing banks will remain the first port of call next year (including those with Government stakes), albeit supplemented by niche, non-bank players offering hybrid structures. International commercial banks will continue to focus on the genuine mid-market space, but if activity remains confined to the smaller end of the market, many will have to decide if they want to move down accordingly, wait for the market to come back, or scale back their activities further. In terms of the top end of the market returning, beyond 2009, it remains a question of if rather than when.



**Mounir Guen, CEO of Mvision Private Equity Advisers, on the general market backdrop and the effect this is likely to have on fundraising and fund performance**

Private equity had a challenging and confusing 2008, and will experience some incredible gyrations in 2009. The new year will bring further constraints, accompanied by chaos and clarity, calamity and calm. There is a whole host of bad news that will reveal itself in the first half, with a number of GPs and LPs potentially making some bad decisions that will further impact the market. In the private markets, the focus is on valuations, covenant breaches, liquidity, losses and ultimately, survival. Meanwhile the public markets generally are not active – a major concern that will further impact the private markets.

We expect fund-raising in the first half of 2009 to be very limited as many GPs postpone their plans to come to market. The average active investor will have half the allocation available compared to 2008, and many investors, especially in the US, will be slow to re-start their programmes as they need a bottom to understand their exposures and rebuild. Large ticket investors will be few, and large funds will struggle to achieve their goals. There are always exceptions, but these will be rare in 2009.

We expect that the private and public markets will hit a bottom in 2009 and be able to rebuild, creating a classic "buy low" scenario, suggesting performance for the coming vintages will be impressive for the private markets. Note that the small end of the market globally – the micro-cap market – is performing, and has been throughout this last year. In 2009 investors will focus primarily on high-quality differentiated brands, micro-cap, distressed and turnaround, mezzanine and credit, and emerging markets. Smaller, more geographically focused funds with supportive local investors are likely to fare better than larger regional funds.