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PRIVATE EQUITY

The changing face of private investment

BY MARK WILLIAMS

It's shaping up as a strong year for private equity. Since September 2003, there has been consistent buyout activity. The last quarter of 2003 and the first quarter of 2004 were particularly hot, setting the pace for LBO values to soar in the US and Europe. Many general partners report that they are busy looking at deals in several sectors, and in a range of countries. Although venture capital performance is lagging the buyout market, there are signs of improvement and rising deal quality. Good opportunities in the mid-market sector, and a general re-alignment of buyer and seller expectations are feeding positively into the deal flow. The pressures of public life – notably increased regulation and investor scrutiny – have prompted many companies to go private, providing a steady stream of opportunities for buyout firms. All this is indicative of steady, stable growth for the private equity market. "We are by no means back to the feverish pitch of the bubble economy, nor should we be," says Sanford Morhouse, a partner and Co-chairman of Dewey Ballantine LLP. "The private equity markets are maturing, and the pace of growth is now sustainable. The business model behind private equity is too compelling to fail," he adds.

Buyouts

In recent years, private equity firms have had to overhaul their investment strategies. Swooping in for a private purchase and following it with a quick sale is no longer feasible in most cases. For a start, many vendors are putting their companies up in open auctions, which erodes the advantage of private equity firms who rely on deal sourcing through their network of corporate relationships. In an expanding marketplace, where new entrants join regularly, auctions also raise the competition levels – and therefore the price paid – for premium acquisitions. The quick sell model is also hampered on the exit side by tougher stock markets and fewer trade buyers.

Private equity firms have lowered their return expectations to compensate for a more challenging market, and returned to the basics of grooming a portfolio company for exit. The new investment model involves conducting more due diligence to properly evaluate the prospects of a potential acquisition, adding real value to portfolio companies through operational improvements, developing an investment team with industry-specific managerial skills, and investing by sector rather than across the board. In short, fund managers have recognised that some hard graft will be required to generate and sustain the returns that investors are seeking – particularly if they are to be lured away from the public markets.

Valuations are extremely important to private equity firms under constant pressure to generate returns. The underlying question is what is the return profile of an acquisition. Conducting bottom-up analysis and due diligence is essential to answering that question and making an informed decision to invest. "Thorough investigation is resulting in tighter valuation ranges and situations where buyout and venture investors are willing to walk away from an investment rather than overpay. Limited partners are paying close attention to pre-money valuation and the return dynamics of general partner investments," says Lawrence E. Penn III, managing director at The Camelot Group. However, exceptional companies continue to push up multiples. John A. Kober, a partner at Morgan Lewis, is seeing multiples for absolute premium deal opportunities in the range of six to seven times EBITDA. "We just did a deal with a private equity firm that was at seven, but that was the highest I've seen in a long time," he says. "That was for an exceptional, well-managed US manufacturing company with operations in China. It was the right time for the PE firm to get into that type of business, and it provided a good exit strategy."

In the battle for good deals, strategic buyers are not considered a serious threat to the buying power of private equity firms. Although trade buyers in certain sectors have gone through a downsizing period and managed to get some profits on their books, many are focusing on core business and are unwilling to use their stock to make large cash investments. Those that are starting to look at expansion are generally unable to match or exceed private equity firms on valuation multiples. "In certain markets, like the US, there is a lot of undeployed capital in the hands of general partners. In Europe there is not the same volume – but there are plenty of US buyout firms looking to invest in Europe," says Mounir Guen, founder and CEO of MVision Private Equity Advisers. Even in cases where a strategic buyer is actively pursuing an acquisition, it is more likely to encourage rather than dissuade a buyout firm to raise its price. "The feeling that many PE firms have is that if a company is attractive to a strategic buyer now, then it will be even more attractive after the financial buyer improves the target's operations," says Ray Newman, managing director at Standard & Poor's CVC – Transaction Advisory Services.

The buying power of private equity firms – fuelled by sizeable cash reserves – is making large deals both attractive and possible. With more firms taking a view to larger and larger deals, syndicates have sprung up to clinch opportunities that are just out of reach of individual firms. The benefit of a syndicate or club deal is that competing firms can find common ground and come together in a joint bid, rather than oppose each other and drive the price up. But club deals are not without their problems. "Syndicated bids are only attractive when there is certainty of closure and credible teams willing to work with each other. Working with multiple buyers can be difficult, as meeting the needs of each syndicate party can present challenges to closing," says Mr Penn. Governance, management rights and exit rights are just a few of the issues that need to be resolved by firms in a syndicate – and they are essentially about control of the deal. "Every private equity fund wants to control its own destiny, and it is enough work to negotiate with sellers, no less with other members of an acquisition consortium," says Mr Morhouse. Syndicated deals naturally involve more complex structures than straightforward single seller situations. This complexity increases when the deal is cross-border and its bidders are international, since unique regulatory and tax issues come into play. Advice given to firms in a club deal is to tread carefully and ensure that clarity and satisfaction are achieved on any issues that may cause trouble down the line.

Given that the IPO market is still relatively tight and strategic buyers are only gradually re-emerging for trade sales, private equity exits are not as free-flowing as many players would like. Sales to other private equity funds are accounting for a good portion of exits, but without traditional routes the market will remain in a state of measured growth. "This is a more mature market, with somewhat lower returns that are still north of what you would expect from public equities. Neither boom nor bust," says Mr Morhouse. Limited exit routes have spurred debate over hold periods. When making an acquisition, some private equity firms prefer to give a reasonable multiple at two or three times with a view to a relatively short exit. Others recognise that they will be in for the duration, perhaps eight years, and are prepared to offer multiples of four or five. The debate is ongoing, and the choice depends on the particular investment preferences of buyout houses, as well as shifting market and exit trends.

Secondary market

The secondary market rose to prominence in the years following the bust, when the capital markets effectively closed and cash-starved trade buyers disappeared. Despite improved private equity activity over the last 12 months, the continued importance of the secondary market suggests that it has established itself as a liquidity alternative and a means by which buyout firms can reshuffle and reorganise their portfolios. "With over $20bn in assets under management and over $7bn in projected transfers, the secondary market is growing faster than ever. Institutions, corporations, public pensions, and high net worth individuals are continuing to utilise the secondary market in order to monetise their assets and increase distributions over time," says Mr Penn. In a period of lengthened exit and returns horizons, the secondary market is a useful bridge for those who cannot afford to wait out an investment. "Secondary markets are allowing PE firms to reach liquidity earlier than was initially anticipated," says Mr Newman.

Nevertheless, there are professionals who believe secondary market could be a lot more creative than it is at the moment. In particular, the mid-market end of the marketplace has some inefficiencies in it, allowing new general partners to get more performance out of a portfolio. "A mid-market company might not have the depth of cash-generative choices, but if a fund manager can merge it with the right platform or management style, value can be added. Each new owner can therefore move the company forward," says Mr Guen. The higher returns attributable to secondary investments suggest that secondaries will be a permanent fixture on the exit list of buyout firms. As firms learn to use the market more proficiently, returns should climb.

Opportunities abroad

Private equity firms are widening their nets to take advantage of developing markets, where cheap capital and cheap labour combine to lower the cost of business. Asia and Central Europe are certainly on the agenda. "Some of our clients refer to Central Europe, especially Poland, not as an 'emerging' market but as a 'converging' market because of the great eagerness in these countries to follow an almost Anglo-American model. Valuations are low, but education is good and the culture is ready for economic convergence with the 'traditional' western economies," says Mr Morhouse.

However, a lot of investment is flowing into these countries indirectly, through companies based in the US or Europe with divisions that allow them to tap into these emerging markets. "Very little PE money is going into companies that are not based in the US or Europe. The attraction is towards, companies based in the UK, the US or Germany, that do business in China or India, for example," say Mr Kober. "PE firms have more confidence not only in the legal framework, but also in the accounting framework. Everyone understands European GAAP and US GAAP," he adds. A lack of financial transparency, inconsistent operational practices and unfamiliar regulatory regimes are limiting the confidence necessary for direct investment. Structural changes will be necessary before many companies reach their investment potential – and the expansion of the EU offers precisely that opportunity. "With Central and Eastern European companies converging into the wider European platform, it is going to create added opportunities. It is similar to what we saw a number of years ago in Spain, Italy and Greece," says Mr Guen.

Venture capital

Venture capital performance in the US market is on the rise, while the less mature European industry is still struggling to deliver the level of returns seen across the Atlantic. Venture capital fundraising is maintaining its momentum from 2003, where Thomson Venture Economics and the NVCA reported that through the six months ended June 30, 2004, 82 firms had raised $5.8bn, compared to 128 firms raising $11.2bn in fiscal 2003. "The fundraising appears to be aimed at early stage investments, while investments in biotechnology and software continue to be a significant part of the investing dollar," says Mr Newman.

In this maturing market, which seems to have shed its fervent character in favour of a more reasoned investment approach, VCs are concentrating on sensible management teams with sound business plans, backed by technologies that offer fairly near-term revenues. A lot of VC firms have had a bad experience in late-stage investments, so many are going back to early-stage. Interest is high in life sciences, biotechnology, medical devices, networking, and media and entertainment. Software remains the number one target of venture capital. "Venture capitalists are proceeding with caution. They are looking at capital-efficient startups which are more likely to grow fast while getting profitable," says Mr Penn.

In venture capital, the exit windows open and close fairly quickly, so investors have to be very alert to capitalise – particularly with respect to the public markets. Present valuations are reflecting the fact that VCs may have to wait longer to generate returns on exit than they have done in the past. "A tight IPO market is forcing a lot of VCs to move into trade sales, which is a fairly new concept for many of them," says Mr Guen. Eyes are on the IPO market, particularly in the US, which has opened up in the last six to nine months for VC-backed companies with stable prospects and demonstrable revenues.

Fundraising

The well-documented capital overhang in buyout and VC funds has declined this year as a result of limited fundraising and increased activity. Industry professionals expect that fundraising will re-ignite in earnest in 2005, perhaps even taking the industry back to the levels seen in 2000 and 2001. Buoyed by rising optimism about the markets, players who have kept a low profile should return to take advantage of greater investor interest. But we can expect that many private equity groups will not hit their targets. "There are more funds that are going out to the marketplace in the US and Europe," says Mr Kober. "These funds are more competitive, whereas five years ago there was only a defined number of funds. In addition, the people running these funds realise that generating returns is more important than ultimate contractual control."

Top firms with strong track records and a signature of success can plan for over-subscription, while those in lower ranks are likely to wait longer to go through, as limited partners re-assess existing relationships and take a more discerning approach to capital allocation. "LPs are more sophisticated than ever before, and make increasingly detailed comments," says Mr Morhouse. Advisers are suggesting to GPs that they prepare to give ground to LPs by reducing fees and basing them on budgets, opening up co-investment opportunities and carried interest splits based on performance hurdles and generally relaxing contractual control. The focus should be on drafting terms that strengthen alignment of interests. "The end result of any closing is an agreement that allows the investor to feel comfortable that the GP will execute investments to the best of his abilities and is transparent about their objectives to avoid surprises," says Mr Guen.

High fundraising expectations and continued market activity are making the prospects for the private equity and venture capital industries look bright for 2005. "We see deal activity increasing over the next few months and really taking off after the uncertainty of the election has passed," says Mr Newman. His view is indicative of widespread anticipation. But the difference between now and the last boom is that many of the deals done today are driven by sensible investment models and competent, proven management teams, which will create a stable, more reliable industry. ■