

# CSFI

## CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

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**The outlook for private equity: A round-table discussion with Jon Moulton (Alchemy Partners), Mark O'Hare (Preqin), Simon Walker (BVCA), and Martin Arnold (FT), held on Thursday, December 4, 2008, at Taylor Wessing, 5 New Street Square, London, EC4A 3TW, from 12:30-2:15pm.**

### **With support from Taylor Wessing**

There was little doubt about the short-term outlook for private equity (PE). The first speaker said it was “clouded”, the third described it as “grim” while the fourth said the entire model was broken. The first speaker said the industry had sown the seeds of its own destruction through its own excesses. He produced a bar chart showing the 10 largest European deals. The top five were bought at between 10 and 14 times EBITDA and with a large debt component. First lien debt was now trading at between 47% and 68% of par. That was a massive loss of value. The megafunds behind these deals carried now had problems with debt payments, portfolio valuations and a lack of investor funds.

On the basis that 70% of funds' capital had not yet been invested with the remaining 30% bearing a heavy loss and many markets closed, funds were looking at negative returns. Prices would have to come down and funds would have to get used to life without debt, he said. The second speaker took a more upbeat line saying that PE firms that took on debt in 2006 and 2007 would struggle but earlier vintages would do well. Secondly the 70% in cash was “dry powder” for future deals. He estimated there was \$457bn uncalled debt across the world while new funds were looking to raise \$317bn.

Looking ahead he agreed new deals would come with less leverage and involve minority stakes rather than majority-controlled investments. He expected to see a huge increase in secondary sales of PE interests, with some sellers even paying buyers to take commitments off their hands. He expected a big change in terms and conditions, especially around fees for fund general partners. He doubted there would be consolidation as the PE sector had always been quite “amoeba-like”. Lastly in the long term he expected to see more money not less allocated to PE given current negative returns on equities.

The third speaker agreed that prospects were grim and tough in the short term. The availability of easy money had made PE funds lazy. Leverage became a too important driver of profit. Now funds must embark on cost-cutting and refocus their emphasis on managing better the companies they own. There were likely to be some divestitures down the road. The next two years will show whether PE funds are run by sharp business people who are excellent at managing or simply first-degree mathematicians adept at financial engineering. He was confident the former was the case. In the long term there was a clear need for liquidity and for investment opportunities. He said the fee system would be restructured. On regulation he said that the industry had made large steps on disclosure on investments, which was no longer an issue. He was most concerned about a new wave of

European regulation that would not so much kill the golden goose as encourage them to fly to Dubai and elsewhere.

The fourth speaker noted that from its peak 18 months when PE believed it had the superior business model, it is now wracked with self-doubt over its debts, valuations and motivation. The model seems broken. One member agreed, saying research had shown that all the profits in PE were down to leverage rather than better management. The speaker said that while the top quartile of funds had beaten the S&P500, average PR returns were simply in line with the index. He said the golden rule was that those funds that were successful once were the ones that continued to be successful as they attracted more money and were able to apply greater leverage. He doubted that remained true now.

He expected the industry to shrivel, pointing to news that 3i, one of the most conservative of funds, was axing jobs. Fees would be cut dramatically and a big shake-out was around the corner. One member said that surely the next two years would be good for picking up companies at a bargain price. The speaker pointed out that no one would want to provide new debt funding at par when existing debt was trading at 50 cents to the dollar. Why catch a falling knife? The first speaker agreed, saying that unwinding of problem investments would be incredibly complicated and would tie the market up for a year. He said that some deals had 11 layers of debt, 800 investors and four jurisdictions.

What does the future hold? The fourth speaker said there were many deals that needed restructuring or were simply heading for bankruptcy. The only game in town will be how to cut losses. The second speaker said there would be failures both within portfolios and of funds themselves – not that PE has a monopoly on failure! But PE's management focus and the alignment of managers' and investors' interests would stand it in good stead. There are great deals to be done. The third speaker said 2009 would be a "rotten" year and echoed a warning of collapse of deals and of PE houses. However he expected conditions to bottom out after a year at which point the industry should use its flexibility and resurface as a necessary force to help deliver wider economic recovery. The first speaker said investors would retreat from the sector. He said PE had to return to remember the conventional story and show how they were well equipped to look after other people's companies. Would the government be interested in bailing out a PE firm? Not a chance, the speaker said, they have far bigger fish to fry.