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CrossCurrents

Ernst & Young's magazine for financial services executives

Trendlines

The state of private equity

Is the private equity (PE) industry going to come out of the downturn weaker or stronger? And what are the key issues that it needs to address?

Key points

- Investment models have to focus on lower leverage, more operational improvement and subsequent recapitalizations.
- PE will remain an important asset class and continue to draw significant investor interest although fund raising will be tough in 2010 and 2011.
- PE firms are focused internally on upgrading back-office operations and externally on strengthening portfolio company performance.

For more information on PE or to obtain a copy of Ernst & Young's report, 2009 US private equity watch: an industry in flux, *visit www.ey.com/us/privateequity.*

With less leverage funding available and increased regulation on the horizon, how are PE firms preparing for the future? There have been reports of a possible industry shakeout, and the recession may yet drive structural changes to the existing PE model. To shed light on these issues, we spoke to John Harley, Ernst & Young's Global Head of Private Equity, and Jeffrey Bunder, Ernst & Young's Americas Head of Private Equity.

CrossCurrents: *PE deal activity has recently returned from a period of relative stagnation in 2008 and 2009. What are the key issues impacting deal flow?*

Bunder: While deal activity was slow for much of 2008 and 2009, it returned in the fourth quarter, and the trend appears to be continuing in early 2010. Leverage is more readily available in North America, and the bid-ask spreads (buyer vs. seller expectations) are narrowing. Valuations are lower than in 2006 and 2007, and owners with stronger capital positions are still reluctant to sell assets in the current market. They have been slow to put assets up for sale, waiting until market pricing improves. Where we are seeing deals is where owners need to sell because of the overall company debt level, with Inbev and Alcan, for example. Certain houses have been very active in the markets and are finding ways to get deals financed and closed. Deal pipelines are building, and PE is more active on the investment side. Some of the pick-up has been observed in bolt-on acquisitions to existing portfolio companies. Funds have also been focused on opportunities in the emerging markets, including China, India and South America, with some of the larger funds having recently established or expanded offices in Brazil.

Harley: PE firms are resigned to holding on to their portfolio companies longer than they have historically, that is, more than four years. According to Dealogic, there were 2,081 PE-backed deals announced in 2009, the lowest number since 2002. As for initial public offerings (IPOs), the market has picked up over the past 12 months. The last four months of 2009 saw a great increase

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in activity, but this was focused on the Americas and Asia-Pacific, with little activity in Europe. This is consistent with historic trends. IPOs are attractive for both houses and limited partners as they facilitate exits, and with fund raising due in 2011, houses are keen to return money to their investors.

CrossCurrents: *What are PE Firms currently focused on? How are they managing value for their investors while dealing with increased regulation?*

Bunder: PE firms are focused on improving their back-office operations to meet increased regulation in Europe and the USA and on the increasing demands of their limited partners for more transparency. In the back office, there is a concentrated effort to improve investor reporting, particularly where they are seeking a public offering themselves. Managing enterprise-wide risk is a common theme among these funds. With portfolio companies, the focus is on strengthening balance sheets and performance, which includes rightsizing capital structures, improving operating efficiency, e.g., supply chain, working capital, cost reduction — often driven by the involvement of executives with operational experience, introduced to assist and/or replace portfolio company management.

From a transaction-process perspective, there has been an increased emphasis placed on due diligence and in particular, on the linking of past performance with forecasted earnings in order to validate the growth thesis.

CrossCurrents: *From your perspective, has the PE model changed?*

Harley: The underlying PE model of acquiring controlling positions in undervalued businesses with executable strategies and strong management will remain intact. However, there will be increased focus on operational efficiency. Many houses are hiring "operational partners" because they recognize that excess returns observed in prior years as a result of increased leverage and multiple expansions will likely not repeat in the next deal cycle. Current investment models may need to be more conservative, and front-end due diligence processes will likely need to be expanded to address more potential investment risks, e.g., IT systems.

CrossCurrents: *The Obama Administration and Congress have proposed that PE firms register as investment advisors with the Securities and Exchange Commission. Will this change the industry?*

Bunder: Although the PE Council testified before the Senate that PE firm activities do not create systemic risk, the PE Council supports the Administration's proposal requiring fund registration. The Council believes that pursuing an exemption for the industry from the proposed regulations would weaken public confidence in the overall reforms. And while the PE Council has cautioned that the proposed regulations could impose a significant administrative and financial burden on smaller PE funds, I don't believe the proposed changes will result in any significant industry changes.

CrossCurrents: *The AIFIM-proposed legislation in Europe is controversial. How will it impact the industry?*

Harley: The original proposals issued by the EU Commission were heavy-handed and tailored more to the issues faced by the hedge fund industry. The revised proposals are more relevant but will force many in the industry to upgrade their reporting capabilities.

CrossCurrents: *Where do you see the industry heading?*

Harley: PE has come a long way from its early days as a pioneer among business entrepreneurs. PE's core value proposition — using engaged ownership and aligned incentives to maximize returns for the long-term investor — remains intact. PE firms that hope to survive must adapt to the new world; historically, many have demonstrated an ability to effectively work through or even thrive in difficult economic times as attractive buying opportunities arise. PE still has substantial funds available for deployment and will remain an important asset class and continue to draw significant investor interest. Δ

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