PEI Alternative Insight

PRIVATE EQUITY INTERNATIONAL

ISSUE 98 | SEPTEMBER 2011 | privateequityinternational.com

FOR THE WORLD'S PRIVATE EQUITY MARKETS

MARKETS IN CHAOS

CRISIS IN THE EUROZONE
Private equity and the euro turmoil

DEBT DISTRESS
The rise and fall of high-yield in 2011

IPO SHOW-STOPPER
The exit window shuts in the US

SECONDARIES SPECIAL
Has the revival already peaked?

THE CHICAGO SCHOOL
GTCR's new generation of leaders

PLUS: *Turkey's Eastern promise; MatlinPatterson doubts; positive signs in Russia; and more...*

Keep calm and carry on

Does the sovereign debt crisis represent a clear and present danger to the future of European private equity? Or is it creating the most promising market conditions in 20 years? It depends who you ask, writes James Taylor

How should private equity view the current turmoil in the eurozone? Some argue that the effect on bank liquidity will be so marked in the next few years that lending will grind to a halt, refinancing will be impossible, and that many managers just won't be able to invest their funds – which probably means it will be the last fund they ever raise. Some believe that international investors will look to reduce their exposure to Europe, instead channelling their money into emerging markets where there's a better chance of strong economic growth. And yet others argue that the crisis will propel quality managers to the fore, reduce competition, bring entry pricing down to attractive levels, and allow the industry to profit from its greatest strengths.

The question is: who's right? *PEI* got five leading professionals – two GPs, two LPs and one debt expert – around a table in London in the second week of August in an effort to find out.

DISAPPEARING DEBT

Private equity may be less directly exposed to the kind of volatility we've seen in the stock markets lately. But it's already feeling the impact on the debt side. In the first half of 2011, it looked as though debt markets were starting to normalise again: high-yield issuance hit record levels, as investors chased better returns, and buyout firms were able to take advantage of this to refinance previous deals. This in turn led to lots of early redemptions for CLOs, many of which promptly re-invested the proceeds, creating a fresh pool of liquidity. According to William Allen of Marlborough Partners, this encouraged the whole market to feel better about itself – the result being that deals started getting underwritten again and leverage levels started to creep up (Carlyle's £1 billion deal for UK breakdown company RAC and EQT's €6 billion sale of alarm manufacturer Securitas were both done on a distinctly toppy seven times leverage).

Unfortunately, this all came to an abrupt end around the time of the second Greek bailout in June. While the banks waited anxiously to see what the damage would be, industry sources say that it became nigh-on impossible to borrow money on reasonable terms.

"The market has quietened right down," admits Allen. "You can still get deals done, but only if you're prepared to pay a very high premium. The banks are very cautious – and given that much of the nervousness within the banking system is linked to the euro, I think we will be in limbo for some time."

In the short-term, this will clearly make it harder for managers to get financing for new deals. "We may well go back to what we saw a little while ago – retrenchment to only the better deals, with only the most credible GPs and the most resilient businesses getting financed," suggests Capital Dynamics' Katharina Lichtner.

By contrast the less fortunate groups, she suggests, may end up needing to ask LPs for an extension of their investment window – and that will force investors to make a difficult choice. "If you say no, you essentially force the GP to go and spend the money, possibly on sub-optimal deals, compounded by not being able to get any leverage. Combined with the moderate growth prospects in Europe, that's really going to put pressure on margins. But if LPs just agree to extend the investment period, then you have other issues like the overall increase of the management fee load for the fund – which may force renegotiations of core parts of the LPA."

This, in turn, is likely to have a big impact on future fundraising, says Pantheon's Helen Steers, because the firms concerned are "putting off the evil hour when they have to go back to the market". If they've had a bad crisis, they're likely to meet with a sceptical response when they try to raise a new fund – not least because LPs will probably be able to be picky. "If nobody can raise funds for another year and a half, many will end up coming to market at the same time," says Lichtner. "As an LP, you don't want to have all your next run of money in one or two vintage years, so you need to spread it out – which by definition will force you to make choices. And that's just going to reinforce the shakeout."

And the trouble is, the banks' euro-related problems are far from over; in fact, Allen believes the worst may be yet to come. "Look at the way the eurozone funds itself. Sovereigns issue short term bonds to the national banks, and the banks take those bonds to the ECB as collateral to borrow more money. If [German chancellor Angela] Merkel gets her way and manages to get rid of this 'no default' principle, then the holders of those underlying instruments are going to have to take impairments. And who are those people? The banks. So the banks are nervous as hell about this, and they're already starting to hoard liquidity." Allen points out that the 90 leading European banks have €5.4 trillion of debt falling due for repayment in the next two years – equivalent to 45 percent of European GDP. "So there's potentially a cataclysmic problem here."

Private equity faces a similar conundrum. Ratings agency Fitch estimated in early August that there are €200 billion of leveraged loans due to mature between now and 2014. Allen reckons Fitch covers about half the market – so if you double that number, and then double it again to include the mid-market (which doesn't fall into the Fitch numbers), you end up with more than half a trillion euros debt due to be refinanced in the next few years. This will be incredibly difficult at a time when the banks themselves will be under pressure to deleverage, and many CLOs will be approaching the end of their investment windows.

Duke Street's Taylor argues that banks will just have to push out maturity dates, whether they like it or not. "Nothing is easy to change in debt, but the easiest thing to change is maturity. I think if the servicing capabilities are there, and there's no alternative, maturities have to move out. There may be a lot of kicking and screaming, but it'll happen."

Allen's not convinced, though. "All the banks have got to de-lever – they're way too leveraged. So I think we've got two or three years of problems when it comes to bank liquidity, and it's going to hit the private equity industry generally when the refinancing wave comes around. I think a lot of companies are going to find it very, very hard to reach agreements to refinance their debt. And I think the banks are going to be a lot wiser about what they get in return."

ROUNDTABLE PARTICIPANTS

William Allen is a partner and co-founder of debt advisory group Marlborough Partners. He previously set up and ran Blenheim Advisory, before selling it to US mid-cap investment bank Houlihan Lokey in summer 2007.

Andrea Bonomi is the chairman of Investindustrial, a mid-market firm that operates in Italy and Spain. Before founding Investindustrial in 1990, he was responsible for the Saffa Industrial Group's investments in Europe and the United States.

Katharina Lichtner is managing director, co-head of investment management and head of the research team at Capital Dynamics, a Swiss-headquartered asset management firm. She was previously a consultant at McKinsey & Company.

Helen Steers is a partner and head of European primary investment at Pantheon, a UK-based fund of funds manager. She's been involved in private equity for 20 years, having previously worked at Russell Investments in Paris and Caisse de dépôt et placement du Québec.

Peter Taylor is the managing partner at Duke Street Capital, a UK mid-market firm that operates largely in the UK and France. He joined the firm from Vardon in 1996, and was made managing partner in 2004.

COMMON CURRENCY

The current political instability in the eurozone also poses huge challenges. The apparent inability of Europe's politicians to agree on a sensible way to resolve the crisis creates the kind of uncertainty that investors hate. Growth prospects for the region are feeble at best, and it's no longer impossible to imagine a scenario where the euro as we know it ceases to exist.

Not surprisingly, some international investors are no longer convinced that Europe represents a sensible bet. "The one part of the world that is most sceptical about Europe is the Far East," says Taylor. "I get more questions there about this kind of thing than anywhere else. So you end up trying to give people comfort on Europe, as if any of us are really qualified to do that. But it's a big issue out there. And although the US has problems too, they just have a stronger sense of direction towards the US than they do towards Europe."

Lichtner, for one, is not surprised that some investors are bemused by the machinations of Europe's political leaders. "It's hard to sit in Asia and understand what's happening between Merkel and Sarkozy and Cameron – particularly behind the scenes, because it is unlikely that anything we see in the news is any reflection of what's really going on."

The fall in the euro's value has also left European investors facing awkward allocation issues, says Lichtner. "For example, if you're a US dollar investor in Europe in the last year, you basically just over-committed by 10 percent. So it boils down to a regional view: if I'm a European investor, how much money can I allocate to the US without ending up being over-committed, and having to face performance erosion once money is converted back into my home currency? Especially for some of the newer investors to the asset class, given the current volatility and lack of visibility, it becomes difficult to find a reasonable allocation for commitments outside of their home currency."

GPs have some awkward decisions to take too – particularly those raising euro-denominated funds, like Duke Street. "When we launched, we canvassed the opinion of existing LPs," says Taylor. "We're majority UK/ minority France, so we said that if we go with a straight euro fund again we're obviously taking a currency risk on sterling – and as a GP, if there's a way to get round that, we'd like to. But the feedback from LPs was pretty unanimous: keep it simple and keep it in euros, because it has more international appeal." (Although it does mean the firm's UK partners will be hit in the pocket: they make their GP commitment in euros, and as Taylor points out, "that's a lot more sterling now!")

"I think we've got two or three years of problems when it comes to bank liquidity, and it's going to hit the private equity industry generally when the refinancing wave comes around"

Lichtner believes euro-denominated funds are still much easier for continental European investors. "You still bear a currency risk on the eventual return, but that's less of an issue because currencies will fluctuate many times before investments are finally sold anyway. The bigger issue is the risk of being over- or under-committed during the five-year window of your commitment when most of the money is drawn. So if an LP's home currency is euros, and commitments are made to euro-denominated funds, at least they're safe on the allocation side."

What's more, the panel agreed (unanimously) that trying to protect against some of this currency risk via hedging strategies was an exercise in futility. "Hedging is extraordinarily difficult and expensive to do," says Steers. "You can't actually work out where you need to hedge, because of the complexity of working out where the ultimate cash flows are in the underlying companies." Lichtner agrees: "The complexity of getting a hedge on private equity alone is usually not worth the pain."

REASONS FOR OPTIMISM

So in light of all this doom and gloom, should the European private equity industry just give up and go home? Not at all, according to our panel.

For one thing, as Steers points out, private equity doesn't necessarily need a thriving economic backdrop. "Macro-economic growth doesn't exclusively drive investment returns. If you look at European buyout performance in the last 15-20 years, we have

not been in a high-growth environment. But we still managed to produce pretty decent returns." Nor is stability a prerequisite, she insists. "Private equity always does well in a period of uncertainty and dislocation, because it creates opportunities. The worst possible thing for this industry is steady-state; you want change and dislocation because that creates the opportunities."

> "Private equity always does well in a period of uncertainty and dislocation, because it creates opportunities. The worst possible thing for this industry is steady-state"

Nor is the threatened GP shake-out necessarily a bad thing. "We believe very much in the manager life-cycle," says Steers. "I don't think every manager is destined to carry on forever. And what we've seen with the crisis is that GPs have actually been accelerated through the life-cycle."

A greater operational focus will clearly be required across the board in order to drive the best returns. But Taylor argues that the climate will also force firms to differentiate themselves better. "Our industry was becoming too commoditised. You have to specialise to differentiate. I can see a future where we end up running more than one fund – one that's focused purely on financial services, for example."

He also thinks we might see some consolidation. "Every industry at some stage goes through some consolidation – why should private equity be different? We've actually had approaches in the last six months from more than one firm that doesn't think it's going to raise another fund and is thinking about combinations. These aren't necessarily bad firms; often they just don't have a coherent view about how to raise another fund." (Though he accepts it will be very difficult to combine two similar-sized firms – as he says, that's never easy to do with people businesses).

Either way, for the firms that survive the shake-out, the market may look a lot more attractive – as Investindustrial already seems to be finding in (supposedly crisis-hit) Italy. "In southern Europe there is a major shift in fundraising, especially in the mid-market," says its chairman Andrea Bonomi. "The international competition has gone, and if you also take out the local teams that are going out of business, it is not a difficult fundraising environment. Quite the opposite, in fact. If you take the maxim that there are normally three groups for every dollar – well if you're operating in the mid-market, and you're adding value, it's more like the other way round."

Italy's implication in the eurozone crisis has had painful consequences for the Italian banks, which despite being strongly capitalised, are being tarred with the same brush as the country as far as the wholesale lending markets are concerned. Says Bonomi: "Take Banco Intesa or Unicredit. Their market caps used to be bigger than Deutsche Bank; they're very solid, they have strong liquidity – but the problem is they fund themselves on the same cost as the country." Oddly, this has led to Deutsche actually increasing its exposure to Italy, at a time when you might have expected it to be drawing back. "This is where they have a competitive advantage," he explains.

ON THE BRIGHT SIDE

Lichtner also argues that the industry isn't totally reliant on a rapid recovery in the debt markets. "The good thing about private equity is that a manager can ride out debt cycles. Investments can be made with high equity portions – and when markets improve, companies can be properly levered or refinanced. Over a five-year holding period debt is required at some point, but not necessarily right at entry." And the industry is, on the whole, less indebted than it was. "There's been a lot of good deleveraging work done in the last two years," says Steers. "I think the forward looking GPs have done an awful lot of that, putting the portfolio companies on a much better footing structurally." Taylor says that Duke Street's portfolio has come down from 4x to about 2.5x – and that's largely just through "good, steady progress".

On the deal side, Taylor also thinks that there's still a good opportunity to make money even if the debt market doesn't bounce back. "I think in the mid market, at least, we have seen entry pricing come down significantly – and if this summer carries on, it's going to happen again. So if you buy a company for, say, €100 million and build it up, make it bigger and better, and sell in five years' time for, say, north of €200 million, I think there is a real opportunity for multiple arbitrage – not necessarily through the recovery of the leverage market, but just because bigger, better businesses always go for higher multiples."

"I think it's way too early to say what's going to happen. Give people some time. It's not such an old currency, and this is the first big crisis that it's had"

And even if the banks do stop lending, this could create an opportunity for someone else to fill the gap, Lichtner suggests – sovereign wealth funds, perhaps. "From our point of view private equity would have an advantage here – it could attract that type of money much more easily than other seekers of capital, because of its structure and the knowledge to work through these types of contracts. So private equity could potentially disintermediate itself from the banks relatively easily, as long as somebody is willing to organise the other side of the table."

Allen agrees that there's a "fantastic opportunity for someone to come in and be an alternative provider of capital" – and indeed, he says that various smaller lenders are already looking at raising a new pool of liquidity for this specific purpose. The problem is scale, however. "If you add up all the current alternative providers, it's still a drop in the ocean compared to what you might need. So someone else needs to come in." And that someone would need to have very deep pockets.

STILL TIME FOR THE EUROZONE

Of course, all our round-table participants agreed that a significant macro event – a sovereign default by one of the larger eurozone countries, for example – could change everything, at least insofar as it undermined Europe's biggest banks. Since economists can't seem to agree on the likelihood of this happening, it's not easy for private equity managers or investors to take an informed view. But our panel was reasonably bullish on the euro's survival prospects.

"Given the magnitude and the complexity of the issue, I think it's way too early to say what's going to happen," says Lichtner. "Give people some time. It's still a young currency, and this is the first real big crisis that it's had. Also from a German point of view, given the historic legacy, I think there is going to be huge emotional resentment about becoming isolated again in Europe."

Bonomi also points out that Germany has some compelling financial reasons to stay in the euro – and to make sure the likes of Italy does too. "Germany cannot have Italy devalue next to Germany, because it would bring them down – the Deutschmark would be even stronger than the Swiss franc is today. Let's not forget that Germany as an export nation is a major beneficiary of the Euro, however much it hurts for them to bail out underperformers like Greece and Portugal. So we are together for good. We can't unravel it – if we could, we would. The only way break-up could happen is if you have revolution on the streets – where the people kick out the politicians and say 'enough is enough'."

Taylor believes we may end up with a smaller, stronger eurozone. "If Greece is fundamentally bust, wouldn't it be better for Europe to let it go? Because as long as the hit is capable of being taken, it will strengthen what remains. My guess would be the euro will still be here in ten years, but it will be a smaller core of the big countries that are really committed."

Either way, the consensus was that we shouldn't underestimate how much is invested in the euro's survival. "People forget that it's not just a macroeconomic question – it's a political and an emotional one," says Steers. "The Euro may only have been in existence since 1999 as a currency, but its roots go way back; it has been a long time in the making." The trouble is, she argues, that monetary union can only happen successfully in the long term in conjunction with greater fiscal and political union. And that won't be easy to achieve, politically.

So can private equity turn a volatile situation to its advantage? It clearly has been able to do so in the past. But the eurozone crisis arguably represents a different sort of challenge. This isn't just about political uncertainty, or financial instability. The industry's fortunes remain firmly wedded to those of the banks, both for financing new deals and refinancing old ones. And if some of the continent's largest banks end up being brought low by the eurozone's sovereign debt woes, it's hard to see how private equity can escape the fall-out. ■