

EXCLUSIVE

THE ROAD TO RECOVERY

Real Deals has been given exclusive access to SCM's latest annual review of the private equity market, which suggests that the asset class should look to the future with cautious optimism.

THE LOANS PARADOX

Despite an indubitable scarcity of debt, bank funding has – counter-intuitively – been dirt cheap, according to SCM Strategic Capital Management's latest annual review.

Leveraged loan and high-yield bond issuance in Europe totalled \$42bn (€34.7bn) in 2009, its lowest level since 2004 and \$14bn less than the finance issued in 2008 (see graph, below right).

Debt multiples also declined. The average debt package for a buyout transaction decreased from 4.8x Ebitda in 2008 to 3.7x last year, and firms had to stump up an equity slug of 50 per cent to secure that financing. Yet despite a slump in financing provision, the average pricing of leveraged loans has dropped. In 2006, private equity houses were paying just shy of 800 basis points for their loans. In 2009 and the first quarter of 2010, pricing had fallen to 475 basis points (see top graph, page 10).

Chunky arrangement fees have, of course, been a feature of the market once again. But even if these fees are costed in, firms are still only paying between 4.5 per cent and 5.5 per cent for their finance.

"For the firms that can get an LBO loan, pricing is very attractive right now, which will have a positive impact on equity returns as the cash flow of portfolio companies will benefit from lower debt servicing costs," says Dirk Lienemann, head of private equity at SCM.

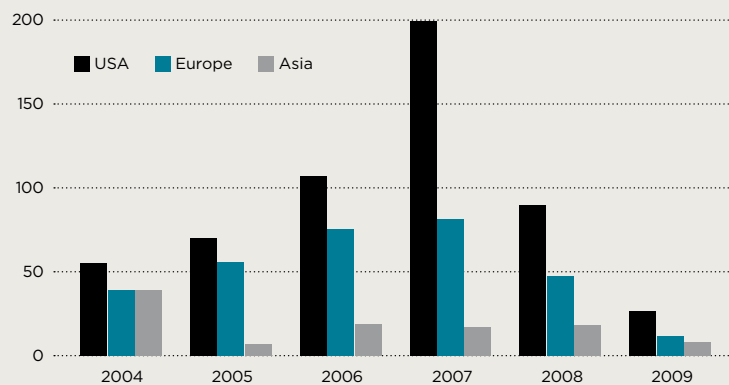
The sustainability of this cheap debt is, however, another matter. Although the overall pricing of LBO loans is lower, banks are enjoying bigger spreads than ever. Banks were taking 449 points above Libor on LBO loans in 2009, compared with 263 basis points in 2006 and 295 in 2007. "Banks are certainly earning more profits on loans than they used to," Lienemann says.

Indeed, it has been record low base rates that have kept the cost of financing low, a situation that will not go on indefinitely.

Lienemann acknowledges that

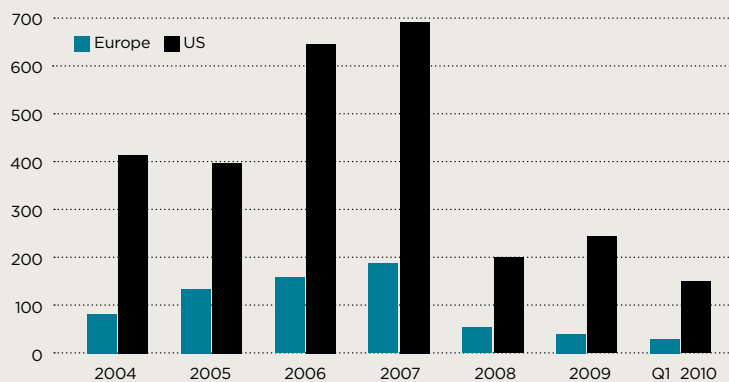
BACK IN BUSINESS?

Global investment volume (equity value, \$bn)



Source: SCM, Dealogic, VentureSource, Thomson

New issuance volume if leveraged loads/high-yield bonds in aggregate (\$bn)



Source: SCM, S&P LCD

if base rates do increase, LBO financing is likely to be more expensive as it will no longer be propped up by loose monetary policy. But supply did start to recover in the first quarter of 2010. Debt multiples of 5x Ebitda and beyond came back into the market, and debt issuance in Europe in the first quarter of 2010 came in at \$31bn, only \$11bn shy of the entire total for 2009.

If supply continues to recover, prices for LBO loans could therefore be kept down, but general partners should be cautious. Last year showed how external factors can turn basic supply-demand economics on its head.

SLOW SECONDARIES

Another anomaly of 2009 was the weak activity from secondaries players. Last year was supposed to be a golden one for this corner of the private equity market. Valuations tanked, liquidity was scarce and limited partners with large private equity portfolios were desperate for cash. Everything suggested that secondaries players were ideally placed to mop up.

The deal data for 2009 paints a different picture, however (see bottom graph, page 10). Secondaries players invested \$9.1bn according to the SCM review, less than half

the \$20bn invested in 2008, and even lower than the \$15bn and \$12bn invested in 2007 and 2006 respectively, when conditions for secondary deals were less favourable. Indeed, SCM estimates that \$13.8bn of secondaries offerings were pulled from the market – a somewhat unwanted industry record.

Gaps in pricing expectations and the surprising willingness of battered LPs to grimly hold on to their portfolios have been cited as the main handbrakes on secondaries deal flow. Rising stock markets, which helped portfolio valuations to stabilise, did not work in secondaries houses' favour either.

"Bid-ask spreads were very wide and the rising stock market in the second half of 2009, alongside bond issues by liquidity-constrained investors, eased the pressure on investors to offload assets at low prices last year. Investors were often able to hold off secondary transactions," Lienemann says.

But although 2009 would have been a major disappointment for secondaries houses, the opportunity served up by the financial crisis has not necessarily passed them by. Pricing has become more sensible, and financial institutions trying to meet solvency and regulatory requirements should come into the market.

SCM's review anticipates that a significant pipeline of private equity funds, worth around \$125bn, will feed into the secondary market during the coming years. The basement prices that secondaries investors were hoping for will not materialise, but there should still be strong deal flow.

"Bid-ask spreads have narrowed since the second half of 2009 and investment committees can now justify selling off portfolios at NAV – or just below NAV – rather than having to sell at the high discounts they faced in the first half of 2009," Lienemann says. "We should also begin to see more secondary deal flow coming from banks and insurance companies over the coming years as they work through

their balance sheet positions. What is certain is that there are not going to be the huge volumes of sales at rock-bottom prices that secondary investors were initially hoping for."

FUNDRAISING BLUES

Perhaps less of a surprise than cheap LBO debt and slow secondaries activity was the weak fundraising environment. Private equity fundraising in 2009 was 79 per cent down on 2008 levels, and in 2009, SCM only reviewed 224 new private equity funds – a 45 per cent drop on the previous 12 months. Funds that did come to market in 2009 often had to reduce their targets.

However, a spectacularly weak investment environment meant that the industry still managed to raise more money than it invested. Lienemann says fundraising activity is likely to remain tepid in 2010 as firms continue to focus on looking after existing portfolio companies rather than a new wave of deals.

"Fundraising this year is likely to remain patchy, especially in Europe. There could be a pick-up in the last quarter of the year, but the real volume is going to hit the fundraising market only in 2011 and beyond," Lienemann says. "The focus of many fund managers at the moment is still on maximising the value within their portfolios and positioning assets for sale."

There will be some firms that try to go to market early with new vehicles, but most houses will sit it out for a bit longer. "Some firms may try to get a leg up and go to the fundraising market earlier – thus beating the expected fundraising wall next year. To achieve this, they will aggressively pursue current investment opportunities and pay very full prices," Lienemann says.

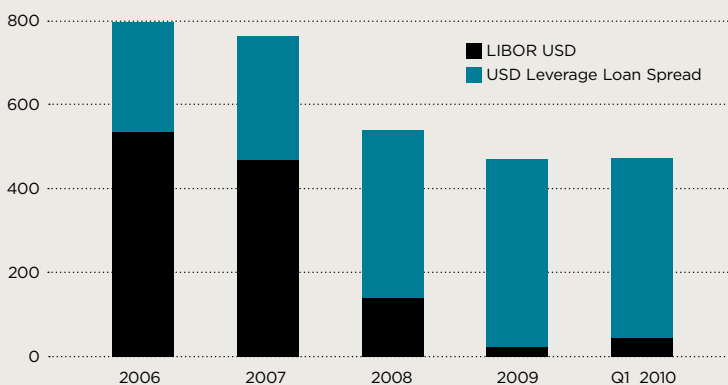
But, those handful of firms aside, the industry is unlikely to go into full fundraising mode until investment picks up. "A revival in fundraising will require deal activity to recover first. Funds need to do deals if they are going to trigger the 70 to 75 per cent thresholds that allow them to go fundraising again," Lienemann says.

DEAL DOLDRUMS

Deal activity in 2009 was poor as firms, faced with macroeconomic uncertainty, problems within their existing portfolios, gaps in pricing

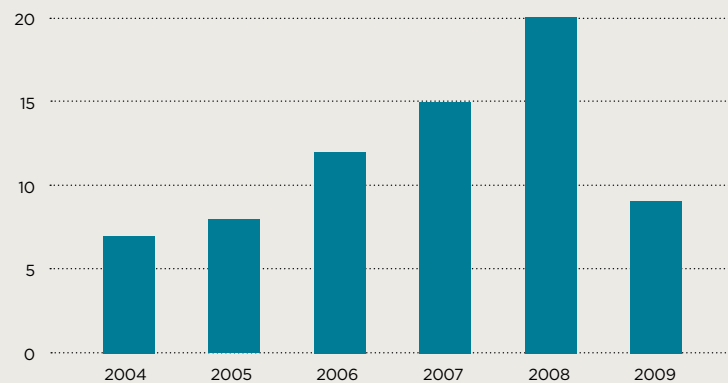
LIBOR'S LABOURS

Average US LBO loan cost (LIBOR + spread, \$bn)



Source: SCM, Bloomberg

Global secondary transaction volume (\$bn)



Source: SCM, Bloomberg

Top-quartile horizon returns on all private equity funds, EU

European private equity performance (at year-end 2009)				
	1 Year	3 Years	5 Years	10 Years
All Venture	-7%	-13.5%	-2.4%	-5.3%
All Buyouts	-13%	-0.2%	15.6%	11.7%
All Private Equity	14.4%	-1.5%	15.4%	10.4%
MSCI Europe	33.7%	-8.7%	2.7%	-1.6%

Source: SCM, Thomson

expectations and a short supply of leverage, decided to sit on their hands and wait for things to settle.

According to SCM, only \$47bn of equity was invested in 2009, compared with \$158bn in 2008 and \$300bn in 2007 (see top graph, page 9). Further, after years of expanding its share of global merger and acquisition activity, the private equity industry accounted for just three per cent of total transaction volume, after reaching a record 16 per cent share in 2007.

But after a weak 2009, the outlook for new investment is

looking rosier. Activity picked up in the first quarter of 2010 as gaps in pricing expectations narrowed.

"Bid-ask spreads regarding valuations of corporate assets are narrowing, and for businesses that can secure debt the pricing is very attractive, so deal activity did pick up in the first quarter of this year," Lienemann says. "We will have to reassess where the market is at the end of the second quarter to see if the recovery has been continuing and shows some sustainability."

But like their secondaries counterparts, buyout dealmakers

need to accept that despite the financial crisis, mouth-watering deals at knock-down prices are simply not going to materialise.

"Buying cheap assets isn't going to happen on a broader scale. Vendors are obviously unwilling to sell at rock-bottom prices, and the quick recovery of the stock market in 2009 has supported that view. The current market situation suggests that overall, firms are not going to get in on the cheap," Lienemann says.

Exits were also rare in 2009. The total value of exits was 44 per cent down on 2008. In 2009, there were only seven buyout-related exits with a deal value greater than \$2bn, compared to 20 deals of such size in 2008 and 31 deals in 2007.

But like investment activity, exit activity rebounded in the first quarter. Private equity managers announced an exit deal volume of \$44bn in this quarter, compared with \$26bn in the first quarter of 2009 and \$48bn in Q1 2008.

THE FUTURE

So where does private equity stand after all the tumult and uncertainty of the past 18 months? Despite all its problems with fundraising, portfolios and new deals, the asset class is still generating unparalleled long-term returns. Cash invested in private equity in Europe ten years ago would have returned 10.4 per cent. The MSCI-Europe is 1.6 per cent down on where it was a decade ago (see table, left).

The industry also looks to be much better equipped to deal with difficulty. Many private equity fund managers have strengthened their in-house leverage, operating and consultancy expertise to get through the recession.

Indeed, while the industry is still trying to recover from the pain of the financial crisis, it has emerged better than many expected and is growing in confidence.

Lienemann is cautiously optimistic that conditions will improve, but warns that private equity is not in the clear just yet. "It looks like private equity has been through the worst, but there is no reason for unrestrained optimism yet. Default rates on loans have not been as high as initially expected, although huge volumes of leveraged loans issued in 2006, 2007 and 2008 will mature over the coming years, and the impact of this will need to be watched closely," he says. ●