

# Chicago Fed Letter

## When Worlds Collide: The Altered State of Private Equity— A conference summary

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The Federal Reserve System's Private Equity Merchant Banking Knowledge Center, formed at the Chicago Fed in 2000 after the passage of the Gramm–Leach–Bliley Act, sponsors an annual conference on new industry developments. This article summarizes the ninth annual conference, held on June 25–26, 2009.

At last year's conference, no one could have foreseen the dramatic changes ahead for the financial system.

In his introduction, Carl Tannenbaum, Federal Reserve Bank of Chicago, noted what a difference a year had made. Speakers at last year's conference had noted the beginnings of financial dislocation and a rapid increase in risk aversion. However, no one could have foreseen the subsequent near collapse of the financial system, the breathless succession of dramatic market events, government interventions on behalf of so many large institutions, and the wide range of special government programs. Despite these events, private equity funds<sup>1</sup> are still robust and are playing a new role as part of the recapitalization of the banking industry.

Charles Evans, Federal Reserve Bank of Chicago, shared his thoughts as the bank's president and CEO on the macroeconomic environment and broader financial market developments, framing the landscape facing the private equity industry. By most indications, the current recession will match or exceed the downturns of the mid-1970s and early 1980s in depth and duration. According to Evans, financial markets, including the short-term funding markets and longer-term bond issuance, have improved since earlier this year. However, the volume of commercial lending (a major source of funding for private equity) has fallen off sharply since the 2007 business cycle peak,

and credit standards for these loans remain tight. Evans said, overall, economic activity is expected to bottom out and then turn positive later in 2009 or early in 2010.

### State of the industry

Sanjeev Mehra, Goldman Sachs Group, surveyed the current state of the private equity industry. During the five-year period leading up to mid-2007, leveraged buyout (LBO)<sup>2</sup> activity increased, driven by access to plentiful and low-cost credit. Leverage<sup>3</sup> ratios also increased, new leveraged loan<sup>4</sup> issuance soared, and credit quality declined. The availability of low-cost financing came to an abrupt end in mid-2007, and buyout activity declined significantly. The industry today faces a wall of refinancing, and debt pricing has not fully recovered. The recession has caused default rates to increase, with further increases expected. Private equity firms are responding to these changes by focusing on managing existing portfolios, refinancing and extending debt maturities, injecting new equity into target firms, investing in new ways (e.g., distressed debt<sup>5</sup>), and waiting for the initial public offering market to provide opportunities to exit and reduce leverage.

Despite the numerous challenges facing the industry, Mehra argued that “reports

of the death of private equity are premature,” citing continued fundraising and a significant “overhang” of money from 2007 funds still available to invest. Top LBO firms have consistently outperformed the public market by providing capital and high-quality resources to target businesses, focusing on value creation, aligning management and investor incentives, and closely monitoring performance.

A panel led by Mark O’Hare, Prequin Ltd., explored private equity valuations. It featured William Franklin, Conversus Asset Management; Thomas Goldstein, formerly of Madison Dearborn Partners; and Erin Hill, One Equity Partners. After

private equity professionals. Providing assistance in this exercise were Thomas Janes, Lincolnshire Management; Martin Magida, of Carter Morse and Mathias; and James Marra, Blue Point Capital Partners. Topics addressed included trends in mergers and acquisitions (M&A), banking as a target industry, private equity industry metrics, and compensation. The most telling trends about the current state of private equity were the drastic decline in M&A activity and sluggish fundraising and deal flow.

The secondary market<sup>7</sup> was analyzed by a panel moderated by Stephen Can, Credit Suisse Strategic Partners; it featured Ethan Falkove, of Neuberger

challenge is particularly acute in the current stormy economic environment. Kathleen Graham, HQ Search Inc., spoke on staffing issues facing the private equity industry, from both the GP and LP perspectives. The presentation, using a nautical theme, centered on the mantra of “Can Do”: *Communicate clearly and completely, Align sails (interests and compensation), Navigate via better decision-making, Do due diligence, and Operate efficiently.*

John Kim, Court Square Capital Partners, led a panel of LP investors, made up of Greg Davis, State of Indiana Public Employees’ Retirement Fund; David Fann, PCG Asset Management; and John Morris, HarbourVest Partners. Panelists indicated that current market conditions have increased the influence that LPs have in setting terms and conditions, including the key area of fees paid to GPs. In addition, long-term shifts in the types of benefit plans administered by pension plans and the trend of private equity funds going public have altered the funding available to GPs. LPs are currently interested in the secondary market, senior bank loans, distressed debt, mezzanine funds,<sup>9</sup> energy, clean technology, and emerging markets. Finally, although (lagging) write-downs in private equity valuations have helped some LPs stay within investment policy limits, future capital calls could once again challenge their ability to adhere to these limits.

#### Leveraged loan market

Meredith Coffey, LSTA, surveyed short-, medium-, and long-term trends in the leveraged finance market. In the short term, technical factors (increasing demand relative to supply) and fundamental factors (soaring defaults and rating downgrades) are moving in opposite directions. In the medium term, the massive amount of leveraged loans issued during 2005–07 will need to be refinanced over the next few years. Collateralized loan obligations (CLOs)<sup>10</sup> had played a key role in financing growth in leveraged lending during the boom, but CLO issuance has essentially ceased. Loan modifications (“amend and extends”) may lengthen maturities for stronger companies and provide some relief. In addition, some of this bank debt

## Presenters agreed that reports of the death of private equity are premature.

years of highly superior performance, private equity saw write-downs averaging 17% as of year-end 2008. Although significant, these write-downs were still much lower than those in other asset classes, most notably public equities.

Panelists concentrated on the impact of recently introduced fair value accounting rules.<sup>6</sup> From a general partner (GP) perspective (see note 1), these rules have created a need for a much broader approach to valuations, using a wide variety of data points. Independent valuation committees and outside auditors are also becoming more actively involved. Some GPs have questioned whether fair value is appropriate for private equity assets, with their long maturities. Limited partners, or LPs (see note 1), note that valuations of the same asset can vary widely across different funds. Valuations can be useful to LPs in assessing the track record of different GPs and in determining asset allocations. The panel concluded that, while valuations are by necessity subjective, the most recent efforts to determine valuations do represent diligent and honest attempts to arrive at fair value.

Steven Pinsky, of J. H. Cohn, moderated a panel examining current industry trends, as well as perceptions, misconceptions, and predictions espoused by

Berman; Mark O’Hare; Carlo Pirzio-Biroli, Deutsche Bank Group; and Philip Tsai, UBS Investment Bank. The global secondary market grew rapidly from 2006 through 2008. Transaction flow slowed down in the first half of 2009. Although both supply and demand are strong, bid and ask prices are far apart. On the seller side, many LPs are facing a severe liquidity crunch, as their net cash flows (distributions less new capital calls) have fallen significantly. Furthermore, for many LPs, declines in the value of other invested assets (such as public equities) have caused the percentage of the overall investment portfolio allocated to private equity to exceed policy thresholds, triggering mandated adjustments.<sup>8</sup> On the buyer side, the secondary market prices buyers are willing to pay have declined sharply. Wary of “catching a falling knife,” buyers are weighing the impact of the fair value accounting rules and the recession on portfolio company performance and GP valuations. In addition, providers of leverage to secondary market buyers have essentially closed for business, further reducing investing activity.

#### GPs and LPs

GPs face the daunting task of determining optimal staffing to accommodate the multiple demands they face. This

may be refinanced in the high-yield bond market, provided this market remains open and relatively healthy. In the long term, Coffey said, the leveraged loan market is expected to be less levered<sup>11</sup> and more expensive, but also more stable.

### **Distressed assets and the banking sector**

A panel on distressed asset investing was moderated by Kenneth Yager, of MorrisAnderson. Panelists were Clifford Brokaw, Corsair Capital Partners; Navin Nagrani, Hilco Real Estate; David Onion, Chicago Capital Holdings; and David Wirt, of Locke Lord Bissell & Liddell. While depressed asset valuations provide an incentive to invest, available capital has declined, and investors will likely remain out of the market through the end of 2009. In the financial sector, recently concluded stress tests at the largest banks were considered helpful in reducing the uncertainty about capital needs. Panelists judged that there was enough private capital available to recapitalize the entire U.S. banking industry, but that mid-tier banks were the riskiest segment in the long term and that rescues for small-tier banks from private sources would be extremely limited.

Richard Decker outlined how his firm, Belvedere Capital Partners, which specializes in acquiring financial services companies, views current opportunities in the banking sector. Although the financial services sector offers unprecedented opportunities for investors, until recently, very little private equity money has flowed into it. Private equity firms face a dilemma of whether or not to become bank holding companies (BHCs). BHCs face much greater regulatory scrutiny and generally may not own controlling interests in nonfinancial companies. However, avoidance of BHC status would require limitation of firms' investment in banks to relatively passive, noncontrolling stakes, with fewer of the control features (such as board seats) investors would normally require. In addition, the banking industry faces major challenges at present, including restoring sound credit fundamentals, improving capital and liquidity management, and building a "fortress balance sheet." Decker

argued that the most important ingredient for success is picking the right management team—one that has the experience and fortitude it takes to successfully run a bank in today's environment.

### **More regulation on the horizon?**

The prospects for private equity regulation were discussed by Michael Tokarz, MVC Capital, as interviewed by Edward Hortick, VCFA Group. Tokarz provided a long-term perspective on this issue. Previously, as a member of Kohlberg, Kravis, Roberts, and Co., he was involved in the buyout wave of the 1980s and the first attempts at regulating private equity, which involved proposed tax changes and the reporting of "highly leveraged transactions." Regarding the current proposal to require registration of certain hedge funds<sup>12</sup> and private equity funds, Tokarz stated that private equity generally does not pose systemic risk because, in his opinion, systemic risk is largely driven by liquidity issues, and private equity, on account of the long-term nature of its assets and liabilities, does not pose such issues. That said, he indicated that certain hedge funds and other very large financial institutions may warrant registration due to potential liquidity risks.

### **The venture capital model**

Susan Boedy, Thunderbird Global Private Equity Center, moderated a discussion on global venture capital, with panelists Jack Biddle, of Biddle Novak Venture Partners; John Dominguez, SVB Capital; Clare Fairfield, Venture Capital Institute; and Randy Mitchell, U.S. Department of Commerce. Based on the number of funds, venture capital is the largest sector of the private equity industry, with 31% of the funds raised to date globally in 2009. However, it represented only 9% of aggregate capital raised, compared with 44% for buyout funds. Despite the financial crisis and an extremely subdued exit market, the amount of investment in venture capital held up relatively well in 2008 and so far in 2009.

Panelists stressed the need for a broader "ecosystem" to support entrepreneurship, beyond the existence of funding markets. The U.S. still leads the world in this regard. They also cautioned that

proposals to increase the taxation of venture capital could adversely affect innovation and risk capital and, thus, the broader economy. Among the sectors projected to be the most active targets of venture investing in the next three to five years were clean technology, infrastructure, and biotechnology. The emerging markets of Brazil, China, India, and Africa were mentioned as highly attractive regions for investment.

### **A long-term, global view**

Adnan Hassan, Mecasa Advisors, provided a wide-angle perspective on conference issues. He indicated that sovereign wealth funds<sup>13</sup> serve their sponsoring governments by reducing volatility in revenues, building up savings, supporting strategic planning, and diversifying earnings streams. While these funds benefit markets through quick decision-making, ample liquidity provision, and protection of the privacy of investees, they have raised concerns because of a lack of transparency, possible political agendas, and placement of assets into foreign hands. Hassan pointed out that "Islamic" finance is a small but rapidly growing market niche that is essentially a form of socially responsible or "ethical" finance, based on risk sharing and personal ties between partners in a transaction.

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Policymakers, confronted with traumatic events such as the collapse of the housing giants Fannie Mae and Freddie Mac, are trying to prevent a global depression while facing financial risks of uncertain magnitude. In addition, state capitalism (whether in Washington, Beijing, or Abu Dhabi) is trumping freewheeling markets—at least for now.

“Traditional” financial values and conservative banking are also returning, benefiting advocates of “Islamic” finance. Given all of these factors, Hassan argued that private equity, based more on long-term relationships than on pure financial engineering, would remain an attractive investment model.

## Conclusion

Presenters at the conference were in general agreement that, despite a dramatically altered financial landscape, private equity’s long-term and well-documented cyclical nature drives favorable expectations of survival and prosperity after “worlds collide.”

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<sup>1</sup> Private equity funds are pools of capital invested by a private equity partnership, typically involving the purchase of majority stakes in companies (not listed on a public stock exchange) and/or entire business units to restructure their capital, management, and organization. The standard vehicle for investment in private equity funds is the limited partnership. The manager of the fund, the partnership’s general partner, makes, monitors, and ultimately monetizes investments for a return on behalf of the investors (the limited partners). Limited partners include pension funds, insurance companies, asset management firms, and fund-of-fund investors.

<sup>2</sup> Leveraged buyouts involve the acquisition of a company using a significant level of borrowing (through bonds or loans) to meet the cost of acquisition. Usually, the assets of the company being acquired are used as collateral for the loans.

<sup>3</sup> Commonly measured as the proportion of debt to equity (also assets to equity and assets to capital), leverage can be built up by borrowing (on-balance-sheet leverage) or by using off-balance-sheet transactions.

<sup>4</sup> A leveraged loan is a bank loan that is rated below investment grade (BB+ and lower by S&P or Fitch, and Baa1 and lower by Moody’s) to firms with a sizable debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) ratio, or it is one that trades at wide spreads over Libor, or London interbank offered rate (e.g., more than 150 basis points).

<sup>5</sup> These are loans of companies undergoing (or expected to undergo) bankruptcy or restructuring in an effort to avoid insolvency.

<sup>6</sup> U.S. accounting rules that expand and clarify the use of fair value (or “mark-to-market”) accounting went into effect at year-end 2008 for most firms. Implementation of these rules has been controversial in the current environment, where some market values are severely depressed and may not represent true economic values.

<sup>7</sup> A secondary market is a market where an investor purchases an asset from another investor rather than from the original issuer.

<sup>8</sup> This phenomenon is known as the “denominator effect.”

<sup>9</sup> Mezzanine funds target debt instruments that provide the layer of financing that has intermediate priority (seniority) in the capital structure of a company, demonstrating both debt and equity characteristics.

<sup>10</sup> CLOs are structured credit securities backed by whole commercial loans, revolving credit facilities, or letters of credit, where interests in the security are divided into tranches with differing repayment and interest earning streams.

<sup>11</sup> That is, less leverage in borrowers’ capital structures will be allowed than in the recent past.

<sup>12</sup> Hedge funds are investment pools that face few restrictions on their portfolios and transactions. Consequently, they are free to use a variety of investment techniques to raise returns and risk.

<sup>13</sup> Sovereign wealth funds are pools of funds set up by sovereign governments to manage funds not needed for short-term purposes.