



July 20, 2009

Private Equity

Obituaries are premature



The financial crisis is not sparing the private equity industry. High uncertainty and a dearth of debt financing are making acquisitions difficult. The volume of new buyouts has slumped dramatically. The recession is hurting private equity (PE) funds' highly leveraged portfolio companies particularly hard. Asset write-downs and lower returns are likely. Last year, European buyout funds lost over 25% in value on average.

But obituaries are premature. Two qualities help the private equity industry in the present crisis. Firstly, many (but not all) PE funds have considerable capital reserves. They can use these reserves to support portfolio companies or to seize new investment opportunities. Secondly, more and more companies are in need of restructuring. Here, private equity can leverage its traditional strengths.

Recession can be a good entry point. A historical comparison shows that the returns of the top PE funds are higher the lower GDP growth was in the year they first invested (vintage year). This suggests that PE funds benefit from price falls during a recession. However, the higher macroeconomic risks need to be taken into account, too. Moreover, not every potential seller is willing to accept drastically lower prices.

Private equity must adapt to new conditions and focus on old strengths. The market is currently highly sceptical of mega or highly leveraged buyouts. The focus is therefore shifting to small and mid-sized acquisitions and minority stakes. There is also growing interest in investments in emerging markets. In future, returns will be driven less by cheap debt and more by the traditional strengths in the operational and strategic modernisation of the portfolio companies.

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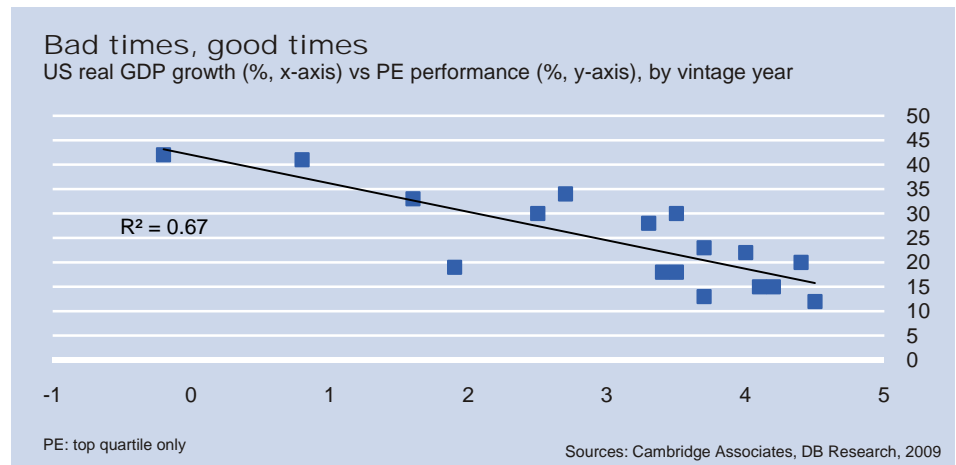
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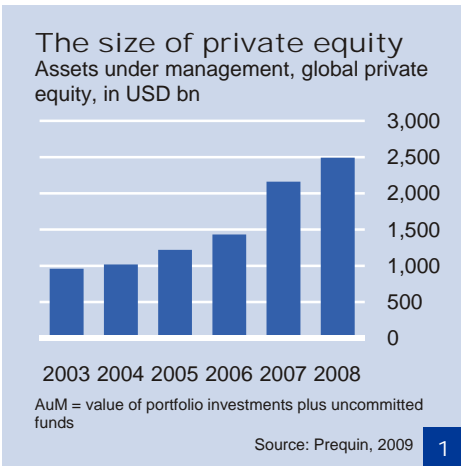
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Private equity (PE) is an established asset class. Hundreds of millions of dollars were already invested by PE funds in the 1970s. However, the volume has grown considerably since then. Last year private equity funds had global assets under management of approximately USD 2,500 billion (see chart 1). The aggregate value of the portfolio companies held by PE funds in 2007 was equivalent to about 2-3% of the total market capitalisation of listed companies.¹

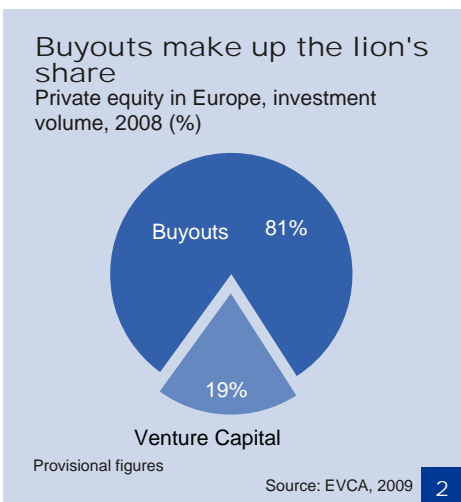
The development of private equity has gone through recurrent phases of acceleration. The 1980s saw a first boom in highly leveraged buyouts (LBOs), i.e. buyouts with a large share of debt financing, along with the spread of high-yield corporate bonds.

From the mid-1990s the New Economy wave sparked rapid growth in venture-capital investments. When the New Economy bubble burst in 2000, VC investments also slumped as the future potential of the start-ups was viewed more sceptically. PE acquisitions of established companies (buyouts) were more robust in this phase.

The next turning point came in 2002. This time it was mainly buyout investments that took advantage. Ever cheaper financing terms, a robust world economy and a glut of funds chasing better returns led to increasingly riskier investments, characterised by high purchase prices and leverages as well as lighter credit conditions (covenants). This boom lasted until summer 2007. Soaring risk premiums for leveraged loans choked off the deal flow and brought the bonanza to an end.

Some listed private equity firms have lost over 80% in value

Since autumn 2008 at the latest the financial crisis has plunged the real economy into a deep recession. This can cause problems especially for highly leveraged buyouts undertaken in the late stages of the boom phase. The equity base is, by definition, thinner and any losses are therefore a greater threat to their capital service. As a consequence, write-downs for those providing equity capital or debt finance are likely. This is making its mark: some listed private equity firms are trading at prices more than 80% below the level at the end of the boom. However, these valuations have also been affected by the downward spiral that has battered virtually all financial stocks since the outbreak of the crisis.



In simplified terms, private equity comprises two segments: venture capital and buyouts. The focus of this study is on the buyout segment, which accounts for over 80% of private equity volume in Europe (see chart 2). The term private equity is therefore always used in this study to refer to the buyout phase. There are separate studies focusing on the VC segment.²

To begin with, the study outlines the fundamental business model of private equity. We then look at the boom phase from 2002 to 2007 and the slump from summer 2007 onwards before going on to discuss the challenges and opportunities for the industry.

¹ The figure has risen to about 4.5% in 2008. This is also due to the fact that share prices worldwide have plunged more steeply than the valuations for PE portfolios. Although EVCA and FASB accounting rules require that PE funds also base the valuation of their portfolio companies increasingly on mark-to-market principles, there is typically a time lag in making the adjustments.

² See Meyer, Thomas (2008). Economic downturn hits start-ups in multiple ways. Talking Point. DB Research. 5 December 2008; Meyer, Thomas (2008). Venture Capital: Bridge between idea and innovation? E-economics 65. DB Research.; Meyer, Thomas (2006). Venture capital in Europe: Spice for European Economies. E-economics 60. DB Research.

Sources of private equity returns

1. **Earnings enhancement:** Strategic and operational improvements at the portfolio companies.
2. **Leverage:** Greater use of debt capital saves taxes and increases the return on equity.
3. **Valuation gains:** Higher valuation multiples when selling the investment thanks to good, often anti-cyclical timing of acquisition and exit.

Long-term investment horizon**Agency conflicts obstruct management****Less coordination problems with private equity****The traditional strength of private equity**

The private equity business model consists essentially of three steps: firstly, buying companies cheaply; secondly, pushing through operational and strategic improvements, and, thirdly, selling the companies at a profit. This profit derives from the growth in earnings as a result of the modernisations made, a higher level of debt (leverage) which increases the return on equity but also risk, and valuation gains in the form of higher exit multiples (see box).

Private equity resolves the governance conflict

Essentially, any company and any other investor can implement operational and strategic improvements themselves. However, PE funds often possess specific advantages that ultimately justify the private equity business model.

Investors make their capital available to PE funds on a long-term basis. As a rule, they cannot withdraw their capital during the life of the fund. The PE fund's portfolio companies are often not listed or are taken private in the course of the acquisition process. This does away with the requirement for regular, public reporting to the capital market, which makes it easier for the PE fund to pursue a long-term horizon as there is less need to react to short-term fluctuations.

Expertise and control

The core competence of many PE funds is in restructuring and the resulting strategic and operational improvements at the portfolio companies. The advantage of private equity is not only that it has the expertise to identify the restructurings that are needed but also that it has the clout to push them through because it typically owns the majority stake. Private equity is therefore essentially a *governance* instrument.

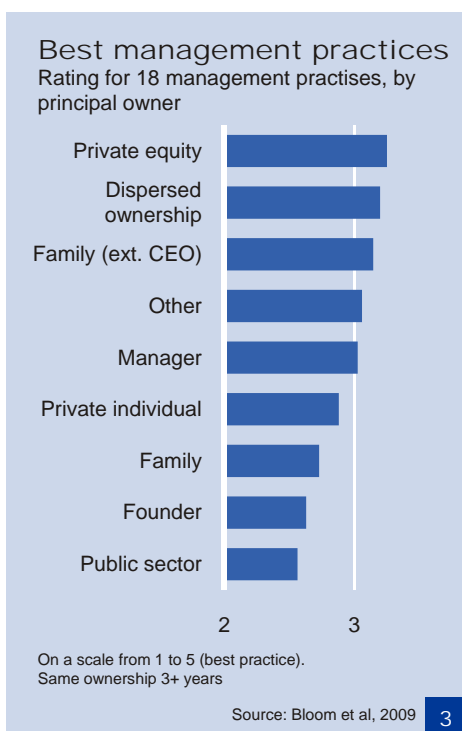
A fundamental *governance* conflict arises at companies today from the separation of management and ownership. Hired managers act on behalf of, and thus as the agents of the owners. The conflicts between managers and owners are therefore referred to as *agency conflicts*. They often result in managers not being interested in maximising the value of the company because this could curtail their own benefits or because they do not need to as the owners do not pressure them.³

PE funds resolve this conflict for, as the principal owners, the effort and cost of overseeing the company's management is worthwhile and there are less coordination problems with other owners. However, in the wake of the financial crisis minority stakes are getting more important: in this case formal ownership rights are replaced by rights conferred by contract, argumentation and persuasion which increases the coordination required compared with a controlling interest.

Empirical research confirms efficiency gains**Best-practice management methods**

Bloom et al. (2009) compare the management practices of around 4,000 companies and rate them according to 18 different

³ See for instance Jensen, Michael C. and William H. Meckling (1976). Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics*, Vol. 3, No. 4, or Jensen, Michael C. (1989). Eclipse of the Public Corporation, *Harvard Business Review*.



PE furthers the effective use of innovations

Higher growth rates with private equity

categories.⁴ PE-owned companies receive the highest score on average for their management practices (see chart 3). Tough but precise targets, the right incentives for employees and executives, and numerous modern processes at the operational level give them the edge. The research also shows: the better the management, the more profitable the firm.

The edge over firms in dispersed ownership, mostly listed companies, is small, indicating that modern management methods have meanwhile come to be in widespread use.⁵ However, this comparison understates the dynamic influence of private equity. The special characteristic of PE funds is that they deliberately target companies whose management methods have deteriorated. There is then a marked improvement after they are taken over.

Innovation focused on business application

Critics object that PE funds cut back long-term investment in research and development in favour of short-term profit maximisation. Empirical studies paint a different picture. An analysis of 495 PE-owned companies reveals the following. Firstly, the number of innovations (measured in terms of patents) remains constant after acquisition by a PE fund. Secondly, the innovations are more focused and are more economically significant. This is reflected above all in the fact that the patents are more frequently cited.⁶ A similar conclusion is drawn by a study at the macroeconomic level comparing experience in 15 European countries. Those with a higher level of private equity investment show a higher productivity gain per patent on average.⁷ Both studies suggest that PE-owned companies do not cut back their innovation activities but continue them more effectively.

Economies benefit from private equity

PE funds deliberately target poorly managed, underperforming companies and ideally turn them into well-managed, highly profitable companies. This not only helps the companies concerned but also increases the efficiency of the economy. Empirical research supports this view. An analysis of 20 European countries for the years 1994 to 2004 reveals that countries with a higher level of private equity investment also show higher growth rates on average. An increase in PE investment by 0.1% of GDP is associated statistically with a 0.2 to 0.8 percentage point increase in GDP growth. This study only takes account of the equity component of PE investment, thus avoiding distortion from the high leverage.⁸

The boom in 2002-2007

The PE market surged between 2002 and 2007. Buyouts are financed with a mix of equity and debt. PE firms set up funds which raise capital from investors (fundraising). This capital represents the

⁴ Bloom, Nicholas, John van Reenen und Raffaella Sadin (2009). Do private equity-owned firms have better management practices? In: The Global Economic Impact of Private Equity Report 2009. World Economic Forum. pp. 3-23.

⁵ See also Holstrom, Bengt and Steven N. Kaplan (2001). Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s. Journal of Economic Perspectives. Volume 15, Number 2. pp. 121-144.

⁶ Lerner, Josh, Per Strömberg und Morten Sørensen (2008). Private equity and long-run investment: the case of innovation. In: The Global Economic Impact of Private Equity Report 2008. World Economic Forum. pp. 27-42.

⁷ Meyer, Thomas (2008). Venture Capital: Bridge between idea and innovation? E-conomics 65. DB Research.

⁸ Meyer, Thomas (2006). Private Equity: Spice for European Economies. Journal of Financial Transformation. Vol 18. November. pp 61-69.

PE boom mainly debt driven

The boom in figures

	2002	2007	CAGR
Investments (equity only) <i>Worldwide, USD bn</i>	77	130	11%
Fundraising <i>Worldwide, USD bn</i>	94	380	32%
LBO loans <i>Europe and USA, USD bn</i>	38	380	59%
Buyouts: 5Y IRR <i>USA, rolling, %</i>	0.6	14.5*	

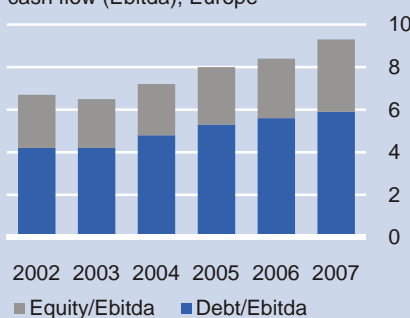
*Sept. 2007

Sources: DB Research, 2009,
S&P Thomson Financial, 2008

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Demand drives up prices

Buyout prices as a multiple of operating cash flow (Ebitda), Europe

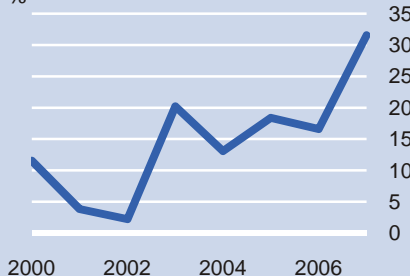


Source: S&P LCD, 2008

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Keeping it amongst ourselves

Exits by sale to other PE funds in Europe, %



Sources: DB Research, EVCA, 2008

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equity component of a PE investment. However, a large part of the investments are financed with debt, e.g. LBO loans.

During the boom years the development of these two components diverged considerably. While the equity contribution to PE investments grew comparatively moderately by an average of 11% between 2002 and 2007, the sums that PE funds raised from investors (+32% p.a.) and the sums taken on in the form of LBO loans (+59% p.a.) exploded. As a result, the leverage in PE deals increased and the funds raised a lot more money than they used for investments (see table).

The strong interest in private equity from investors (both equity and debt) can be explained by the prolonged phase of growth of the world economy during this period. Gushing corporate earnings and historically low default rates made the risks appear small. Moreover, the banks were able to place an ever larger proportion of their LBO loans in the capital market and thus reduce their own exposures.

Money chases deals

The high returns at a time of low interest rates encouraged many investors to increase their allocations to alternative forms of investment. This holds especially for traditional PE investors such as insurance companies, pension funds, trusts and high-net-worth individuals. At the height of the boom in spring 2007 China also decided to invest part of its foreign exchange reserves in PE.

The glut of capital held by PE funds fuelled competition for the most promising investment opportunities. In Europe, for instance, purchase multiples rose between 2002 and 2007 from 6.7 to 9.3 times operating cash flow (see chart 5).⁹ This figure even understates the explosion in acquisition prices. Many companies had already strong growth in cash flows anyway as a result of the good business situation. In other words, the valuation multiples were not only higher but were often also applied to a much inflated base.

While PE funds typically acquire underperforming companies, it is plausible to assume that these companies also profited from the good business situation and earned higher profits than in leaner times.

Good for sellers

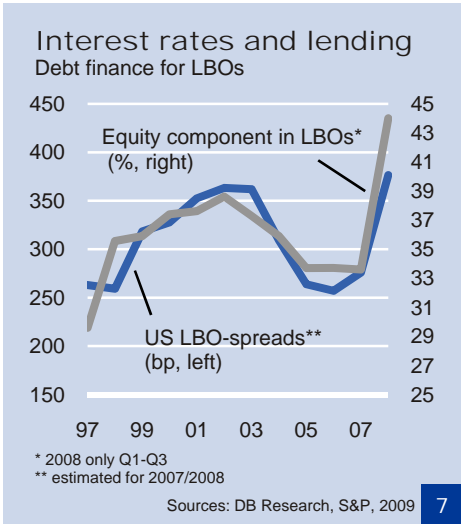
The winners in this development were above all the sellers because they were able to obtain high prices for their firms. Many former owners sold off their firm or parts of it at good terms.

Among the sellers who profited from the good times were also many PE funds that sold on their portfolio companies to other financial investors. During the boom years sales to other PE funds acquired ever greater importance as an exit channel. In 2007 they accounted for over 30% of the exits in Europe (see chart 6). The elevated prices were therefore both a bane and a boon for the industry.

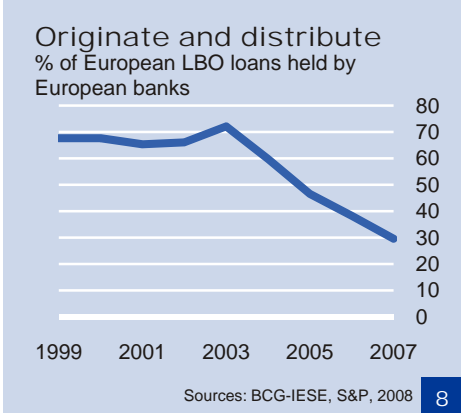
High purchase prices typically mean declining returns on new investments. In a study conducted by Jerry Cao and Josh Lerner a strong negative correlation was found to exist between fundraising volumes and private equity returns.¹⁰ After all, high fundraising increases the pressure to invest and drives up prices.

⁹ Company valuations are typically expressed in the form of price multiples, in other words a multiple of a given performance measure (e.g. Ebitda).

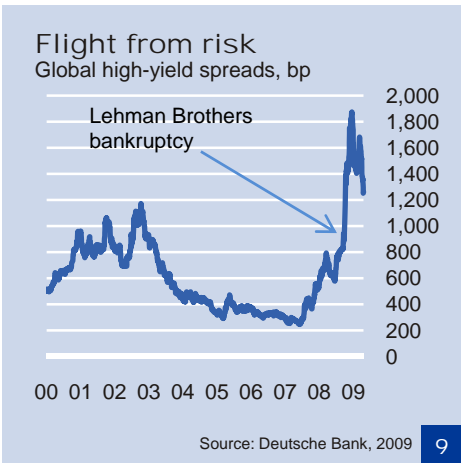
¹⁰ Cao, Jerry and Josh Lerner (2007). The Performance of Reverse Leveraged Buyouts. Mimeo.



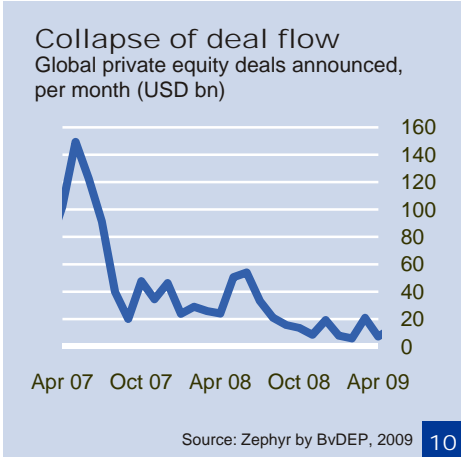
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However, the funds that exited their investments during the boom years profited from the price trend. They were able to realise potentially high profits and, with this performance, attract new funds.

Leverage has to compensate for declining earnings expectations

Rising earnings typically lead to declining earnings expectations. The higher earnings rise, the more difficult it becomes to hold this level. A mean reversion to lower, long-term averages is probable. Declining earnings expectations should therefore have come to be reflected in lower purchase multiples. This was obviously not the case because the development was distorted by other factors.

One factor especially was the exuberant capital market environment. An ever greater proportion of the buyouts were financed with debt. The banks were competing fiercely for clients, so loans were extended at low rates of interest and on lighter covenants. The average equity contribution to European buyouts fell from 38.6% in 2002 to 33.6% in 2007. Chart 7 shows the close correlation between financing costs (expressed in terms of the spreads on LBO loans) and the level of leverage.

However, the lower level of equity financing helped to keep purchase prices rising because it enabled PE funds to still earn high returns on equity despite the elevated price tag.

The creditors were able in turn to offload part of the credit risk by securitising the loans and placing them in the capital market (*originate and distribute*). Here, too, there was growing demand for products offering higher yields. By 2007 the share of European LBO loans held by European banks had fallen to 30% (see chart 8).

The boom ended in summer 2007

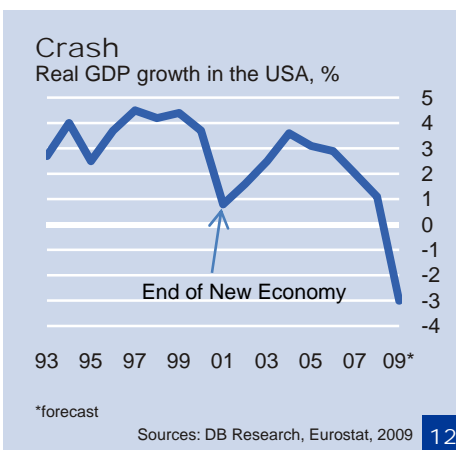
The crisis with subprime loans led to a general flight out of risky assets. The spreads on high-yield bonds surged from around 250 bp in June 2007 to nearly 450 bp in August 2007. With the escalating financial and economic crisis the spreads went on to reach almost 1,900 bp in January 2009. The situation is easing slightly at present but the level is still above the peak for the last cycle, indicating the severity of the crisis (see chart 9).

The sharply increased risk aversion has hit the private equity segment hard because its credits belong to the riskier financings.¹¹ The market prices for outstanding LBO loans or the structured products packaged from them have plunged. Banks and other providers of debt capital have had to make heavy write-downs on their portfolios. New exposures are difficult to place in the market, i.e. only at high interest spreads.

This crisis is having numerous effects on the PE industry:

1. The volume of new acquisitions has contracted sharply. In June 2007 buyouts worth over USD 120 billion were announced. In June 2009 the figure was only USD 9 billion (see chart 10). In the financial market there is scepticism especially towards large and highly leveraged acquisitions.
2. On the other hand, small and mid-sized buyouts by PE funds are still taking place. The number of acquisitions has not fallen by far as strongly as volume (see chart 11).

¹¹ The correlation coefficient between high-yield spreads and the spreads on US LBO loans is 0.9.



3. Banks currently have to keep a larger proportion of the LBO loans on their own books again: in Europe the proportion rose from just less than 30% in 2007 to 56% in the first three quarters of 2008.¹²
4. The level of leverage in new buyouts has come down appreciably. The average equity component in European buyouts rose to 45% in 2008. That is a jump of over 10%-points year over year and an historical high for the industry.¹³
5. The credit squeeze also affects PE deals that have already been completed because a large part of the loans extended on these deals will have to be refinanced in the next few years. The Bank for International Settlements estimates that around USD 500 billion needs to be refinanced between 2008 and 2010.¹⁴ It is to be expected that the volumes will be smaller, the covenants stricter and the costs higher.
6. The sale of investments (exit) is also very difficult in times of high uncertainty and sharply falling valuations. Collapsing equity markets make IPOs unattractive. Moreover, many buyers are waiting to see whether prices might fall further. The growing importance of strategic investors is likely to continue. According to provisional figures, their share of exits in Europe rose from 28% in 2007 to 39% in 2008.¹⁵

Economic crisis hits portfolio companies

The crisis, which began as a financial crisis, rapidly spilled over to the real economy. Global growth slowed appreciably in 2008 and the world economy will see a considerable contraction in real terms this year. We currently forecast a decline of about 2.8% in GDP in the USA (see chart 12) and about 3.0% worldwide.

The economic crisis is also hurting companies in the portfolios of PE funds. Especially buyouts of the boom phase – acquired at high prices and highly leveraged – face difficult times because consistently strong cash flows are needed to service the capital. If revenues fall short, it becomes increasingly probable that the debt service obligations cannot be met.

This assessment is also reflected in the trend on the secondary market. The average price for leveraged loans collapsed dramatically, especially in autumn 2008 (see chart 13). Besides the higher probability of defaults, the sharply increased risk aversion among investors and the low market liquidity were other factors contributing to this price fall.

It is not only the providers of debt capital that are affected. PE firms and their investors bear the brunt of the burden first as potential losses reduce a company's equity.

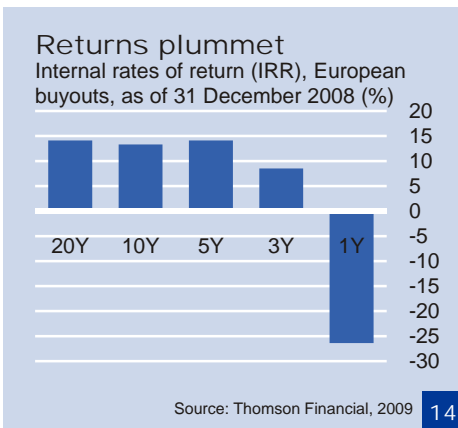
These losses in value imply the expectation of declining returns for PE funds and PE firms. A marked drop in returns was to be seen at the end of 2008. The internal rate of return (IRR) for European buyout funds fell to -26% in 2008. The long-term average is a good

¹² Meerkatt, Heino and Heinrich Liechtenstein (2008). Get Ready for the Private-Equity-Shakeout. Will This Be the Next Shock to the Global Economy? BCG and IESE.

¹³ S&P LCD, 2009.

¹⁴ BIS (2008). Private equity and leveraged finance markets. Committee on the Global Financial System. CGFS Papers No. 30.

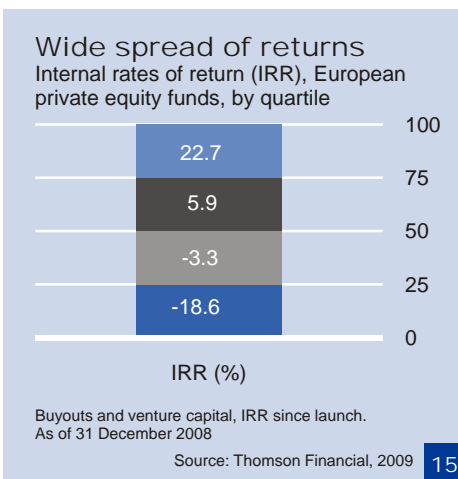
¹⁵ EVCA (2009). Private equity activity slows during 2008. Press release of 12 March 2009.



14% p.a. (see chart 14).¹⁶ It needs to be borne in mind, however, that the past year was a difficult year for most asset classes. Equity markets suffered even stronger setbacks in some cases: the S&P 500 in the USA, for instance, lost about 40% in value in 2008.

Another factor to consider is that the average returns for private equity conceal strong differences between individual funds. For instance, the best performing top quartile buyout and venture capital funds in Europe have achieved a return of 22.7% since their launch, while the worst performing quartile made losses for investors with an internal rate of return of -18.6%. At the same time a high persistence in performance can be observed (see chart 15). The managers of top funds are often able to achieve high returns on the next funds.¹⁷ These funds are so sought after by investors that they are often heavily oversubscribed. Existing investors typically enjoy privileged access; new investors sometimes have to make do with other funds.

But the crisis also presents new investment opportunities, which might enable the returns to be stabilised. This would only be reflected in the statistics in the mid term because PE investments typically generate negative returns in the first years (so-called J-curve effect).



Fundraising dries up – but reserves not yet exhausted

The dismal economic outlook makes it difficult for PE funds to raise new funds. Some institutional investors have to reduce their allocations for private equity owing to their internal guidelines.

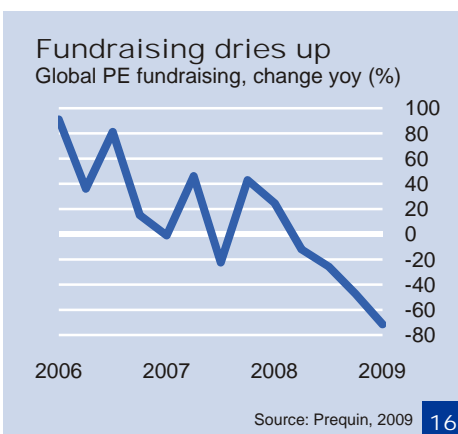
Global fundraising volume had already stabilised at a very high level in the years 2006 and 2007. In the course of 2008 capital flows then became a good deal tighter; especially funds for mega buyouts hardly find new investors. However, thanks to the high starting level and the relatively strong start to the year, 2008 still counted among the good fundraising years: global fundraising was down by a comparatively moderate 11% year over year.

It was only from the second quarter of 2008 that volume took a dive. Fundraising in Q1 2009 was over 70% down versus the first quarter last year (see chart 16). It is also taking longer for PE firms to fill up their funds. Last year it took an average of 15 months to close a fund; the year before it was only 12 months.¹⁸ This illustrates that it is becoming increasingly difficult for PE funds to find investors.

However, the current reluctance displayed by investors is also an opportunity for new investors to subscribe to funds that would normally be filled entirely by existing investors. This not only gives them access to investment opportunities that would otherwise not be available; it also means they can rise in rank and participate in future fundraising rounds.

Dry powder of USD 500 to 1,000 billion

However, the coffers of many PE funds are still well filled because in the past years the industry raised a lot more funds than it invested. A considerable reserve of uncommitted funds has thus accumulated. It



¹⁶ However, academic studies reveal that average private equity returns are not systematically higher than those of other forms of investment after allowing for fees. See e.g.: Kaplan and Schoar, 2005; Gottschalg et al. 2008.

¹⁷ See Kaplan, Steven N. and Antoinette Schoar (2005). Private Equity Performance: Returns, Persistence, and Capital Flows. *The Journal of Finance* 60 (4). pp. 1791-1823.

¹⁸ Prequin (2009). 2009 Global Private Equity Review Special. Private Equity Spotlight. February 2009, Volume 5, Issue 2. p. 10.

Fundraising is not a restricting factor

is estimated that PE funds have capital reserves in the region of USD 500 to 1,000 billion as “dry powder”.¹⁹

These funds can be used, on the one hand, to inject capital into troubled portfolio companies and help them through the recession. On the other hand, PE funds can use the reserves for new investments and thus benefit from favourable entry prices.

Where to invest?

PE firms’ core competence is to increase the profitability of the portfolio companies through operational and strategic improvements. Underperforming firms are therefore attractive acquisition targets since they offer much room for improvement. It is difficult at present to find lenders for traditional, highly leveraged buyouts. But since many PE funds have well-filled coffers, they will start to search for alternative investment opportunities. Attractive are all asset classes whose price levels have come under particularly heavy pressure. In addition, the investment focus is shifting towards small and mid-sized buyouts, acquisition of minority stakes and investments in emerging markets.

Buy when others sell

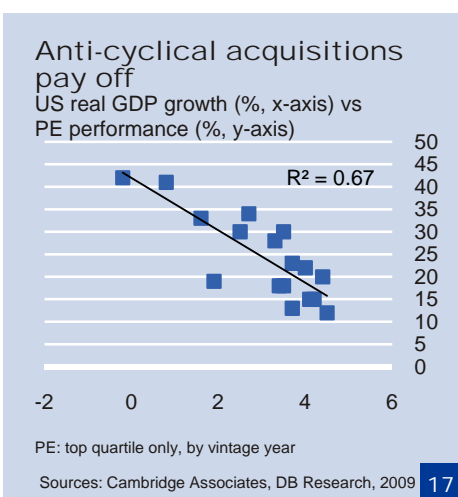
The economic crisis, slumping corporate earnings and growing risk aversion have caused valuation levels in many asset classes to tumble. Many PE firms therefore argue that the present crisis is a good entry opportunity. After all, some companies and other forms of investment such as distressed debt are cheap.

An historical comparison confirms this view. Comparing the returns of the top PE funds that began investing in economically weak years with those from better times shows a clear correlation: the lower GDP growth was in the year a PE fund first invested (vintage year), the higher its rate of return. The growth differences explain about 67% of the variance in the rates of return (see chart 17). This suggests that the favourable valuations more than compensate for other drawbacks in economically weak years, e.g. tighter and more expensive debt finance.

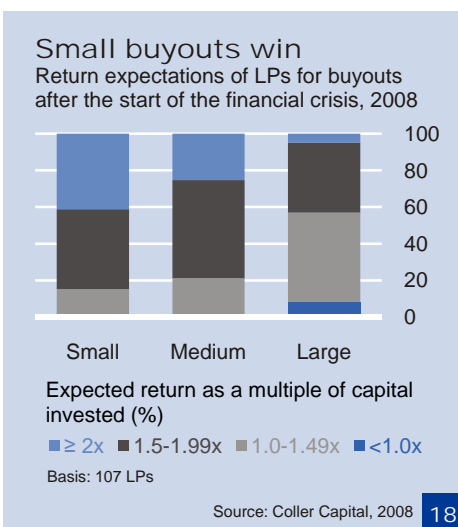
Such assessments naturally entail a high measure of uncertainty. After all, if that were not the case, there would be no price fall because everyone would already be buying. Moreover, many potential sellers are reluctant to sell in this market environment and are waiting for better times. That limits the opportunities for new business.

Trend towards smaller buyouts

Many PE funds are turning to smaller acquisitions as large buyouts are difficult to finance at present. However, structural considerations also play a role. In a survey of PE investors, the limited partners (LPs), small buyouts were considered to promise the highest expected returns and large buyouts the lowest (see chart 18). Often, the strengths of private equity can be particularly effective with small buyouts. Small, privately run companies frequently lag behind in the use of modern management practices (see chart 3 on page 4) and therefore offer correspondingly much room for improvement.



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¹⁹ The range results from different calculation approaches. See Kehoe, Conor and Robert N. Palter (2009). The future of private equity. The McKinsey Quarterly, April 2009, and Preqin (2009). Private Equity Spotlight. February 2009. Volume 5. Issue 2.



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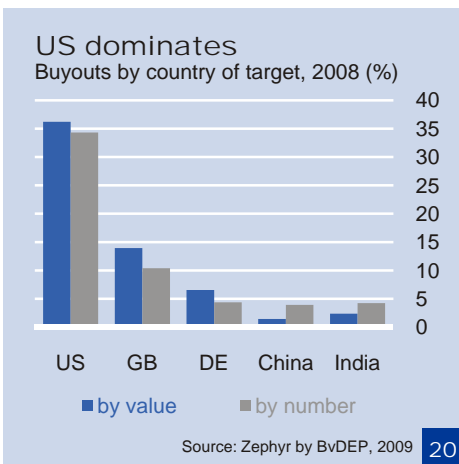
Minority instead of majority stakes

The advantage of a minority stake is that less capital needs to be invested. Given the difficult capital market environment a minority stake is often the only possibility for investing in large companies. This explains why the share of buyouts with a minority stake rose in the course of last year – with a pronounced spike in the crisis month of November (see chart 19).

However, the success of this approach requires that a minority stake is sufficient to effectively exert influence on a company's management. Active investors may become mouthpieces and opinion leaders for an otherwise passive or fragmented group of owners. In this way they can forge the necessary coalitions and muster considerable clout to shape the direction of the company.

The limits to this strategy are obvious. Special contractual provisions, good arguments and powers of persuasion have to take the place of own majority control. This narrows the scope since not all decisions are suitable for broad discussion, and the other owners are not always willing to follow. Moreover, the need for compromises can obstruct more sweeping restructurings and thus limit the potential returns.

Too many minority stakes can dilute the profile of private equity. There is the risk of PE funds themselves becoming passive investors. It would then be hard to justify the higher fees compared to other investment funds.



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Investments in emerging markets

At present, investment targets in the US and Great Britain predominate. They account for about 50% of buyouts in terms of value and 45% of the number of buyouts (see chart 20). Only 4% of buyout value and 8% of the number of buyouts are in China or India. But this is likely to change because more and more LPs want to invest in the Asia region – preferably in China and India.²⁰

China, India and other emerging markets have achieved impressive growth rates in the past years. They are also proving more robust than many industrial countries in the crisis. PE investors want to profit from this trend, too.

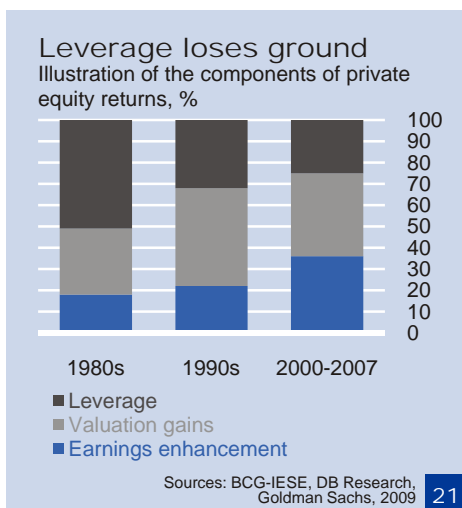
However, it is not clear whether private equity can leverage its specific strengths to the full here. After all, the corporate challenges in emerging markets differ from those in industrial countries. Here, it will be necessary to develop management solutions that are tailored to the respective countries.

Private equity will adjust to new conditions

As discussed at the beginning, the success of PE investments derives from earnings enhancements through the more efficient management of the portfolio companies, the valuation gains achieved through the skilful anti-cyclical timing of the investments, and leverage.

The importance of these different return components shifts in response to changing framework conditions. In the 1980s the financial leverage delivered most of the profit as it was only during this period that broad and deep markets for high-yield corporate bonds evolved. This period peaked with the RJR Nabisco takeover

²⁰ See Coller Capital (2008). Global Private Equity Barometer. Winter 2008/2009. pp. 7-9.



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The systemic risk is low

Carrot and stick

Unreasonable drawbacks are not warranted

The boom years laid the foundation for exaggerations

in 1988. Since then leverage has declined in importance as a component of PE returns (see chart 21).

Given the continued difficult capital market environment the importance of leverage is likely to decline further as debt capital will likely be in short supply and expensive for the time being. The refinancing of existing credit lines alone will be a challenge for many portfolio companies.

The picture for valuation gains is mixed. PE funds that invested heavily at high prices at the height of the boom face write-downs. On the other hand, those that used the boom for fundraising but invested little can now benefit from favourable entry prices – provided the economy quickly moves back onto a growth path. As the funds are positioned very differently in this regard, this will probably contribute to a further widening of the spread of returns for PE funds.

Regulation with a sense of proportion

The reform of financial supervision is one of the main consequences drawn from the financial crisis. Although there is broad consensus that the activities of private equity firms have not caused the financial crisis,²¹ many critics are calling for stricter rules for them.

The European Commission presented a draft directive for the regulation of alternative investments at the end of April. This covers hedge funds and other alternative forms of investment including private equity.²² It requires that PE managers and their funds be registered if the assets under management exceed EUR 500 million. In addition, it provides for further reporting requirements and risk management rules that are not specified in more detail as yet. It is required that PE managers report extensively not only to the supervisory authorities but also to other interest groups, e.g. the employees of the portfolio companies. To strengthen the Single Market the Commission also proposes to introduce a EU pass for managers of alternative investments. This permits EU-wide business activities once they are authorized in one EU member state.

The proposals are too vague as yet for a proper assessment. As a general principle, regulation should be with a due sense of proportion. Private equity strengthens the innovativeness and competitiveness of an economy. The systemic risk is small. Unreasonable drawbacks for the industry are therefore not warranted. Furthermore, distortions of competition must be avoided. After all, little would be achieved if the activities were driven towards non-European funds or informal investors.

Private equity must focus on traditional strengths

Private equity benefited particularly from the global economic upswing between 2002 and 2007. Strong capital flows, exuberance

²¹ A report published by the European Central Bank in 2007 estimates the systemic risks for the banking sector from LBOs as being small. ECB (2007). Large banks and private equity-sponsored leveraged buyouts in the EU. The report by Jacques de Larosière to the European Commission in February 2009 does not contain any specific statements on private equity or proposals for the future regulation of private equity. The final report of the G20 Working Group 1 on improved regulation and transparency of March 2009 identifies the growth in less regulated and supervised capital as a weakness of the present financial system. Private equity is cited as an example – together with hedge funds and banks' off-balance-sheet vehicles – without going into its specific characteristics.

²² European Commission (2009). Financial services: Commission proposes EU framework for managers of alternative investment funds. Press release IP/09/669 of 29 April 2009.

on the financial market and the stable macroeconomic environment put the industry in party mood. The high investment pressure and the growing competition for the best investment opportunities, however, also laid the foundation for exaggerations: acquisition prices and leverages were driven ever higher.

Lower returns likely

Since summer 2007 the financial market crisis has radically changed the environment. The supply of debt finance for acquisitions dried up. The portfolio companies are labouring under the present recession. On top of that, the equity base at many portfolio companies is too thin to weather more prolonged loss-making phases. Expiring credit lines need to be refinanced in difficult financial market conditions. So private equity funds, too, have to make high write-downs on their portfolios in some cases. Returns are likely to be lower. This holds especially for funds that invested heavily at high prices during the boom phase. New investments can profit from the currently lower valuations but must factor in less and more expensive debt finance.

Expertise and capital reserves open up new opportunities

Nonetheless, obituaries are premature. Private equity has two qualities that are very useful, especially in this situation. Firstly, many (but not all) PE funds raised a lot more money in the boom years than they invested. This means they have considerable capital reserves in the region of USD 500 to 1,000 billion. They can use these funds to support portfolio companies and to seize new investment opportunities that emerge in the economic crisis. Secondly, in times of crisis there is growing demand for what traditionally is private equity's core competence: the ability to increase a company's efficiency and profitability through restructuring and modern management methods.

The business model has to adjust to new conditions

The difficult financial market environment, however, makes adjustments necessary in the private equity business model. There is currently scepticism in the capital market towards mega or highly leveraged buyouts. The focus is therefore shifting in favour of small and mid-sized acquisitions and minority stakes. At the same time there is growing interest in investments in emerging markets because this is where the higher growth potential is seen. However, there is the danger here that PE funds might not be able to leverage their core competence to the full, thus diluting the profile of PE.

The industry therefore faces a number of challenges. It needs to master the recession, work off the exaggerations from the boom years, and restore the confidence of investors and lenders. The theoretical and empirical research shows the private equity business model to be essentially solid.

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