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# Struggling for survival

**Private equity was the darling of the investment world in the five years between 2003 and 2007, enjoying exponential growth fuelled by cheap liquidity, growing profitability across industries, rising asset prices, and strong support from investors. Today, amid the global economic slowdown, the private equity industry is struggling for survival in the face of "a perfect storm".**

According to new research from The Boston Consulting Group and the IESE Business School, between 20 and 40 per cent of the 100 largest leveraged-buyout (LBO) private equity firms could fail within two to three years. More alarmingly, the study's analysis shows that almost 50 per cent of 328 LBO portfolio companies could default on their debt – estimated at about US$1 trillion – in the next three years. This figure could rise further as profits decline.

**Heino Meerkatt**, the co-author of a white paper called *Get Ready for the Private Equity Shakeout*, says the private equity industry is facing bleak times. Meerkatt, who presented the paper at the seventh annual INSEAD Private Equity Conference, says that's because few companies are available for sale, the IPO (initial public offering) market has broken down, corporations have no appetite for acquisitions, banks are reluctant to lend, and investors are constrained from making further investments due to overallocation of assets in private equity.

## Covenant breaches

Speaking to INSEAD Knowledge on the sidelines of the conference, Meerkatt, a senior partner and managing director of The Boston Consulting Group, reckons that a majority of portfolio companies in the US and Europe will be in "serious breach" of their debt covenants.

"We are probably seeing 50 per cent or even higher, depending on how deep the crisis will go, where the equity is washed out.

"Does it create a bloodbath? I hope not. But this is, I would say, one of the biggest issues looking forward," said the INSEAD alumnus who graduated in 1990.

History suggests that investing in times of economic turmoil could pay rich dividends, says **Richard Wilson**, a partner at private equity firm Apax Partners. Pointing to the bursting of the telecoms bubble in 2001, Wilson, who was also a speaker at the conference, notes that asset prices and stock markets had plummeted at that time, while leverage financing was also not available. But just two years later, the telecommunications industry managed to recover.

"I think, in reality, if you stand back and look at this situation in 10 years' time, you'll think this was a great time to have been investing," says Wilson.

"In fact, these times are the times that private equity makes the best returns."

## Viable without leverage?

But is the private equity business model of using leverage to make out-sized profits still viable, given that banks are turning off the leverage-financing spigot?

Wilson replies that leverage is just one arrow in the private equity quiver. Private equity also generates returns from rising price-to-earnings multiples, as well as revenue and income growth. The investment portfolio he oversees at Apax Partners has an average CAGR (compound annual growth rate) of between 16 and 17 per cent in terms of EBITDA (earnings before interest, taxes, depreciation and amortisation) over 10 years.

But even without leverage financing from banks, the private equity industry still has untapped capital of US$450 billion, according to Meerkatt's research. However, private equity firms are making few investments amid the current global economic downturn, partly because of declining corporate earnings, a sharp fall in price-to-earning multiples, and the move by many institutional investors to reduce their asset allocation in private equity.

## A chicken and egg situation

Furthermore, there is a mismatch in the prices of what private equity firms are willing to pay and what companies are willing to sell for, says Meerkatt who calls it a "chicken and egg question".

Companies are unwilling to sell amid the economic downturn because their valuations have fallen significantly from one to two years ago, while private equity firms won't pay premium prices, given the weakening corporate earnings and declining valuations.

"Would you sell a company today if you won't have to sell it? Probably not, you would rather like to keep it and wait, unless you have to sell it, if you need cash, if you're in distress," says Meerkatt.

"That's why I believe the market, the leadflows that we see these days come more where there is, as I say, a distressed seller."

## How private equity will be reshaped

On the question of how the global economic crisis will affect the private equity industry, Meerkatt believes there will be an industry "shakeout", as investors will pump new money in private equity players that have profited from the boom years by selling more companies than they acquired. Conversely, those private equity firms that invested heavily during the boom years will find it difficult to raise new funds from investors.

Agreeing, Wilson says that investors will pick private equity funds based on their long-term performance and what differentiates them from the competition. He believes that the top quartile performers will survive while some of the bottom quartile performers will disappear.

In addition, how the industry shakeout will affect individual private equity firms will largely be driven by four key factors, according to Meerkatt's research with IESE professor Heinrich Liechtenstein: the timing of the firm's fundraising needs, its long-term performance, the timing of its recent acquisitions and divestments, and its exposure to default-prone industries.

But given the lack of good investment opportunities at reasonable prices, are private equity firms under pressure to reduce their management fees and return the untapped capital to investors if they're not making new investments?

Meerkatt says that while private equity firms are facing pressure to reduce their fees, investors will nevertheless stick to the companies that have strong track records.

"There will be LPs (limited partners or investors) who basically say, 'we give you the management fee, stay tuned, keep the team, we know you're the best people in the industry and please, whenever it makes sense, invest'."

*The seventh annual INSEAD Private Equity Conference was held at the school's Europe campus in Fontainebleau on May 22.*

*Heino Meerkatt co-authored Get Ready for the Private Equity Shakeout with Heinrich Liechtenstein, an assistant professor at IESE Business School.*

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