

# The Outlook for Private Equity: Third and Fourth Quarter 2008

October 2008

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## Introduction

The financial crisis of 2007-2008 continues to roil markets as it evolves into one of the worst credit seizures since the Great Depression. The primary root cause of the current crisis, as in past financial crises, is overleveraging. There are other common features with past financial crises as well, including a crisis in investor confidence, massive risk aversion, widening credit spreads, a re-pricing of debt, de-leveraging, a sweeping re-pricing of assets and a lack of liquidity in financial markets. This has led to failures among some of the world's leading financial institutions. Coordinated efforts among the developed countries have yet to lead to a recovery in confidence and the unlocking of the credit market freeze.

While the current turmoil shares many common features with past crises, it differs markedly in one way: unlike past historical events, the credit crisis of 2007-2008 has seriously damaged confidence in the financial system. All asset classes, including capital-intensive private equity, have been hurt as investors have fled any type of risk. For private equity, the decline in economic prospects and the unavailability of favorable financing have been particularly challenging. The adverse effects of the credit crunch were initially felt with the decline in the number of buyout deals executed in 2008.

The year 2008 has not been as active a year for private equity since many of the strategies require large sums of capital. Deal volume has slowed due to the lack of available financing. It has also become increasingly difficult for private equity firms to raise capital, given the pervasive risk aversion of investors on a global scale. According to Preqin, as of the third quarter of 2008, only \$88 billion was raised by 129 funds, the lowest total since the first quarter of 2005. Fundraising has been particularly inactive in Europe whose banks are reeling from the banking crisis. Buyout funds are no longer the most popular type of private equity as evidenced by the sharp decline in capital raised in 2008, and the frozen credit markets have limited the amount of financing available for private equity deals. It is rumored that the current limit is \$2 billion for financing private equity deals.

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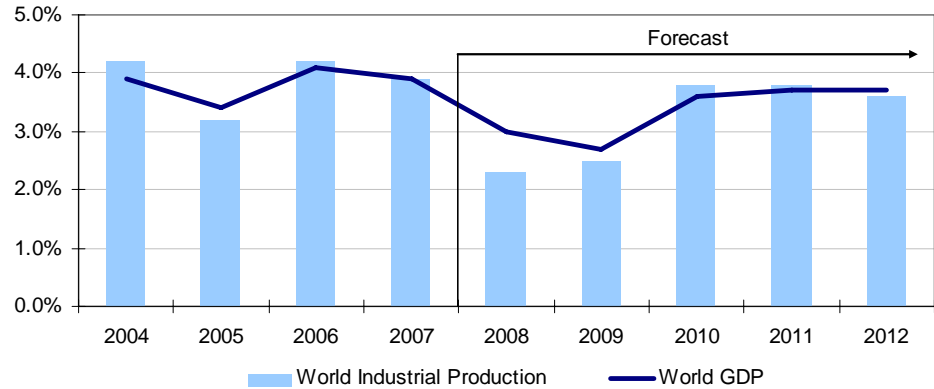
This quarterly update is divided into four parts. Following the introduction, we provide our outlook for the global economy. Next, we look at how the private equity market has changed in view of the financial crisis. This is followed by a review of private equity deal activity and returns. We conclude the report with our private equity trends at a glance.

## Prospects for Global Economic Performance: 2008-2014

The financial crisis has made buying companies difficult for buyout firms large and small. The weakness in global economic performance, on the other hand, is impacting underlying fundamentals of many private-equity owned firms as well. The outlook for earnings growth of many corporations that have been purchased recently in leveraged buyout deals is tied directly to underlying economic growth. This section provides some forecast highlights of economic performance from around the world.

The deterioration in financial conditions emanating from the US is likely to lead to a marked slowdown in economic growth worldwide. Following several years of uninterrupted, above-trend performance, we expect world GDP growth to average only 2.7% in 2009. This marks the weakest pace of growth since the Asian financial crisis a decade ago. The slowdown stems from a US economy in recession, a prolonged seizure in credit markets, corrections across global equity markets, contracting trade flows and major adjustments in key exchange rates.

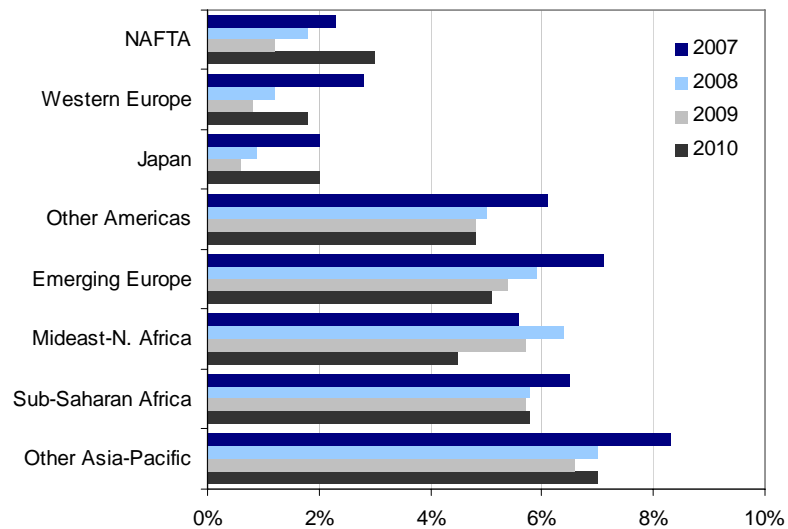
**Exhibit 1**  
**Global Economy is Closer to Recession**  
 (annual percent change)



Source: Global Insight and RREEF Research

Failure to resolve the current financial crisis could easily push the global economy into recession next year as growth falls below 2%, the threshold for global recession. The intensification of the financial market upheaval in the Fall of 2008 is leading to a much more protracted downturn globally.

**Exhibit 2**  
**Real GDP Growth Slows Across Regions**  
 (annual percent change)



Source: Global Insight

Economic growth has downshifted across the majority of regions in 2008 and 2009. With the exception of the Middle East and North Africa, beneficiaries of elevated oil prices, economic growth should decelerate across most regions of the world.

Much of the current weakness is concentrated in the major industrialized nations. The US is spiraling into recession; real GDP is expected to contract later this year and through the first quarter of 2009. The US has been hit by a trio of shocks including a severe housing market correction, tight credit conditions, and high oil prices.

The Western European economies also face many of the same challenges. Several of Europe's economies including the UK, Ireland, Spain and Italy are either in recession or at the brink of recession. The UK and Eurozone are being hit by tight financial conditions, housing market corrections, a strong euro, higher inflation and high oil prices. As centers for global finance, New York and London are by far the most vulnerable to the loss of jobs resulting from the on-going credit crisis. The US and Western Europe should begin the path to recovery by 2010, as housing markets stabilize and financial conditions improve.

The slowdown in the Western industrialized nations has transmitted to Asia as well. A deceleration in exports to the US and Western Europe has put the brakes on double-digit growth in the region. Asia Pacific still remains the world's fastest-growing region, but its growth has downshifted much faster than anticipated. Asian equity markets are down substantially as well, among the hardest hit during the financial "dot.com" bust of 2008.

Japan, the world's second largest economy, is facing a number of challenges, including weakened exports, muted consumer spending, and a lack of business confidence. Real GDP growth in 2009 should fall below 1%. Longer-term, the Japanese economic growth will be limited due to an aging and shrinking population.

Following the Beijing Olympics, China's economic growth should slow as well. Exports and fixed business spending are slowing in response to global conditions, a weaker dollar, higher inflation, and earlier monetary tightening by Chinese officials. By all accounts, the Chinese real estate market has cooled and the equity bubble has burst. Real GDP growth will fall to less than 9% in 2009, following several years of double-digit gains. India faces accelerating inflationary pressures and the monetary authorities have raised interest rates on a number of occasions. Tighter monetary policy is restraining the economy and real GDP growth is also expected to slow to less than 7% in 2009.

Longer-term, the balance of economic power will shift to the emerging economies across Latin America and Asia. They have not been immune to the current credit crisis but are in a much stronger position to withstand adverse global conditions than they were a decade ago. Their fiscal balance sheets and reserve holdings are much healthier as they have benefited from strong commodity exports and sizeable export earnings. The 54 emerging markets should account for over half of the world's growth and output over the next several years.

## **The Prospects for Private Equity**

If anything, the current financial crisis and economic contagion have taught investors that global markets are interconnected. The volatility and loss of confidence in financial markets are not isolated to any one region, asset class or institution in particular, but is a widespread phenomenon from which no one has immunity, not even private equity. Buyouts have lost traction over the past year with the fallout of the credit market. M&A activity has been propped up by consolidations in the financial sector, yet overall activity remains markedly down on a year over year basis. Even the prospects for venture capital look uncertain as investors are concerned about the exit environment for such deals. In all, any momentum for recovery in the private equity market generated since the credit crisis began has dissipated in the past few weeks, signaling that the cyclical bottom for the asset class is imminent.

### **Deal Financing**

For General Partners (GPs), market turmoil has created more uncertainty regarding how to execute deals in light of the challenges facing their industry. Most notably, the loss of leverage

is making deal financing extremely difficult. By some estimates, the current threshold for loans is \$2 billion, with banks typically unwilling to lend in excess for any one deal. The response to this has been two-fold: first, GPs are executing more club deals where multiple parties are involved. This arrangement gathers enough capital for large-scale deals, but profits are split and the volume of deals done increases to put committed capital to work. Second, GPs are looking to multiple financing sources to pool capital for individual deals, but this is becoming difficult as the failure of one institution to lend can cause an entire deal to collapse.

Some deal-makers have said that in addition to the lack of available debt, price stickiness is keeping them from doing deals. There is a widespread fear of overpaying for assets; especially given that valuations are likely to continue to decline due to the softening economic environment. Given the limited capacity for sponsors to complete deals, we foresee a number of possible consequences: most deal activity will be on hold until well into 2009, and any deals that are done will be the result of a specialized focus on the part of GPs and represent a flight to quality.

## **Sponsors**

The recent failures and restructuring of financial institutions with private equity exposure are also changing the competitive landscape of the market. Bear Stearns' and Lehman Brothers' private equity fiduciary fund of funds practices attract the interest of their respective new owners JP Morgan and Neuberger Berman LBO, whereas the direct and merchant banking private equity units will be either spun-out or liquidated. Perhaps more interesting though, is the change in status of Morgan Stanley, Goldman Sachs and Merrill Lynch (via its merger with Bank of America) from brokerage firms to bank holding companies and the impact on their private equity businesses. By becoming bank holding companies, these firms are limited in how much capital they can commit to internal private equity funds due to strict capital reserve requirements. Smaller commitments can result in diminished returns thereby making private equity a lower margin business. As a result, these banks could restrict how much private equity they are involved with or divest of the business completely. Many bank holding companies such as Citigroup, Bank of America, UBS, Credit Suisse and HSBC have in-house private equity groups but operate on a much smaller scale with much less bank capital. This will mean the end of any large-scale dominance by any one bank and will put more institutions on equal footing.

## **Fundraising**

Private equity fundraising is becoming increasingly more challenging in today's markets. The routing of the global public equity markets is causing many investors to be over-allocated to private equity while the reduced pace of distributions from their portfolios limits their capability of self-funding commitments. Overall needs to conserve liquidity, coupled with a lower outlook on returns, results in investors shying away from private equity, lower fund closings and prolonged capital raising periods.

According to Preqin, funds raised in the third quarter of this year totaled \$88 billion, the lowest amount since the first quarter of 2005 when \$64.8 billion was raised. The amount for the third quarter of this year also represents a 51% decline from the second quarter, when fundraising finished at \$180 billion. Sovereign Wealth Funds (SWFs) who are still flush with capital, are unlikely to cover the shortfall in fundraising. Many SWFs, who are recent players in the market, have yet to see realized returns on their private equity investments and will therefore hold off making further contributions until the asset class begins to perform. There is still plenty of dry powder in the market that will fund deals as soon as the pricing and credit gridlock eases. Nevertheless, once that capital runs out there could be a potential vacuum in deal funding due to declining fundraising activity.

## Deal Activity and Returns

There is overwhelming evidence that private equity is near the nadir of its current investment cycle. Data from Dealogic shows the total value of buyouts across the globe in the third quarter plunged 58% to \$55.8 billion compared to the same time last year while the volume of financial sponsor-backed M&A transactions posted a 70% decline vis-à-vis a similar nine-month period. Investors fear that any deals done during the peak of the cycle when valuations were at their highest will end up performing poorly now that the market has bottomed and exits appear difficult. A recent Financial News article cites three-quarters of the record \$1 trillion of buyouts in the 12 months before the credit bubble burst were done by just 25 private equity firms. This has caused investors to fear that their level of risk is highly concentrated and the elevated prices paid for assets will result in worse-than-expected returns.

Furthermore, on the buyout side, another harbinger of lower returns is the uptick in LBO-related bankruptcies. While the overall number of bankruptcies remains low compared to the total number of deals done, adverse market events have led to an increase in the rate of failures. Indeed, one or two bad portfolio investments can hamper the performance of an entire fund. As an example of how widespread the current economic and financial crisis is, commonly cited reasons for bankruptcy include lower demand for goods, soaring input costs and inability to service debt. This occurrence also applies to minority/strategic stakes that private equity firms have been taking when outright buyouts are impractical. Most recently, TPG saw its equity evaporate in the \$1.35 billion cash-infusion of Washington Mutual.

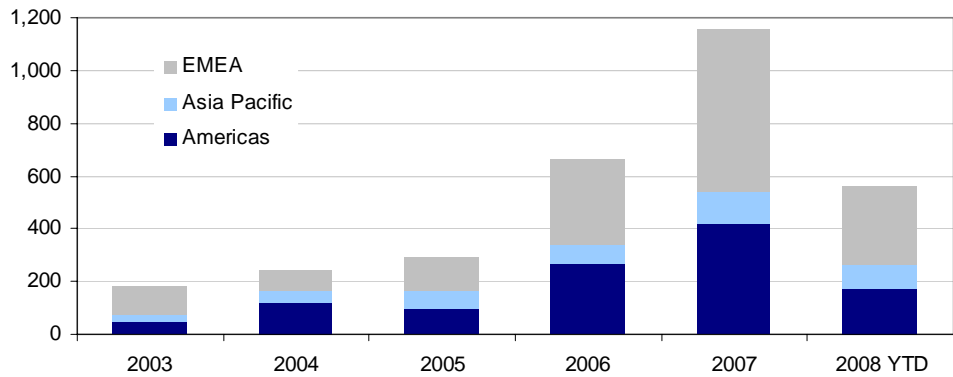
**Exhibit 3**  
**Select LBO-Backed Bankruptcies of 2008**

Company	Date Filed	Sector	Sponsor	Reason Cited
EOS Airlines	April 26, 2008	Airlines	Golden Gate Capital/Sutter Hill Ventures/Maveron LLC	Unable to pass increasing fuel prices onto its customers
Sirva Inc.	February 5, 2008	Automotive	Clayton, Dubilier & Rice	Struggling real estate and credit markets
Motor Coach Industries	September 24, 2008	Automotive	JLL Partners Inc.	Lower demand and higher commodity costs
Propex Inc.	January 18, 2008	Building Products	The Sterling Group/Genstar Capital	Unable to service debt
Wellman Inc.	February 22, 2008	Chemical	Warburg Pincus	Increased competition and commodities costs
Pierre Foods Inc.	July 14, 2008	Consumer Products	Madison Dearborn Partners LLC	Soaring food costs
SemGroup	July 23, 2008	Energy	Carlyle Group and Riverstone Holdings LLC	Failed oil hedging strategy led to liquidity crisis
Ciena Capital LLC	September 30, 2008	Financial Services	Allied Capital Corp.	Deterioration in value of assets because of economic insecurity, decreased demand for new loans
Hospital Partners of America	September 24, 2008	Health Care/Medical	Tailwind Capital Partners	Operating losses and liquidity concerns
Portola Packaging Inc.	August 27, 2008	Manufacturing	Wayzata Investment Partners LLC	Increased raw material costs and lower demand
Ziff Davis Media Inc.	March 5, 2008	Media	Willis Stein & Partners/DLJ Merchant Banking Partners	Leverage prevented the company from developing competitive Internet-based offerings, leading to declining demand and advertising revenue
VI Acquisition Corp. (Vicorp)	April 3, 2008	Restaurants	Wind Point Partners	Rising food costs with soft consumer spending in restaurants
Sharper Image Corp.	February 19, 2008	Retail	Sun Capital Partners	"Liquidity crisis" thanks to slowing sales
Mervyns Holdings LLC	July 29, 2008	Retail	Sun Capital Partners and Cerberus Capital	Tightening of lending terms combined with decreases in consumer spending
Jevic Holding Corp.	May 20, 2008	Transportation	Sun Capital Partners	Housing and credit crisis led to lowered volume of motor vehicle shipments

Source: peHub.com and Buyouts Research

Fund performance will also be heavily impacted by the inability of deals to make it across the finish line. So far this year, the following deals have been withdrawn: Penn National Gaming (US), Alliance Data Systems (US), Asciano (Australia), Friends Provident (UK), Korea Exchange Bank (Korea), Informa (UK), Close Brothers Group (UK), NIBC (Netherlands), Biffa (UK) and 3Com (US) amongst nearly 1,000 others. M&A activity appears to be up according to league tables; however most of the activity has come from the financial sector where deals have been executed under duress. Expect more apprehensive investors to terminate deals at the slightest sign of trouble.

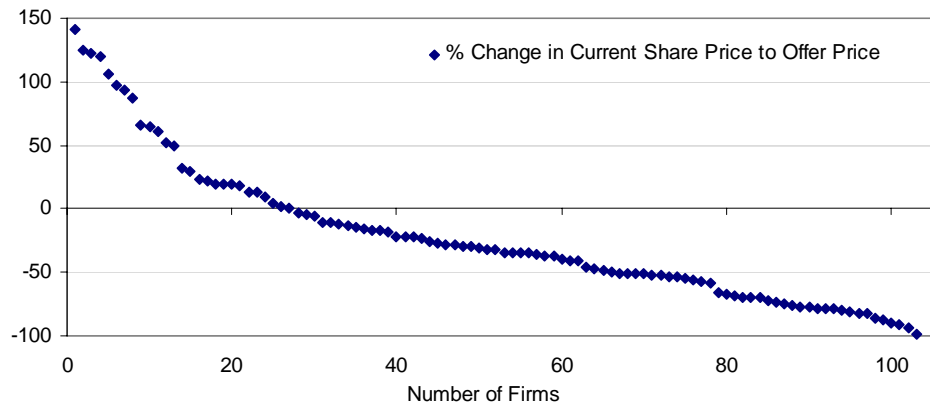
**Exhibit 4**  
**Withdrawn M&A Activity (\$B)**



Source: Dealogic

Finally, the outlook for venture capital appears as muted as it does for other private equity sectors. Due to capital constraints, VC investors have been forced to write off poorly performing portfolio companies in order to focus on firms that are expected to succeed. But even the perceived viability of a start-up firm by venture capitalists doesn't necessarily translate to the public market. M&A activity for venture deals has been weak and the IPO market is even less inviting. In the US, 103 VC-backed companies IPOed between October 1, 2006 and September 30, 2008. In the past two years, 76 of those newly public firms have seen a decline in overall share price since their offering. A similar trend has been seen in Europe. Until a sustained era of confidence returns to the public equity markets, venture capital will be approached with caution.

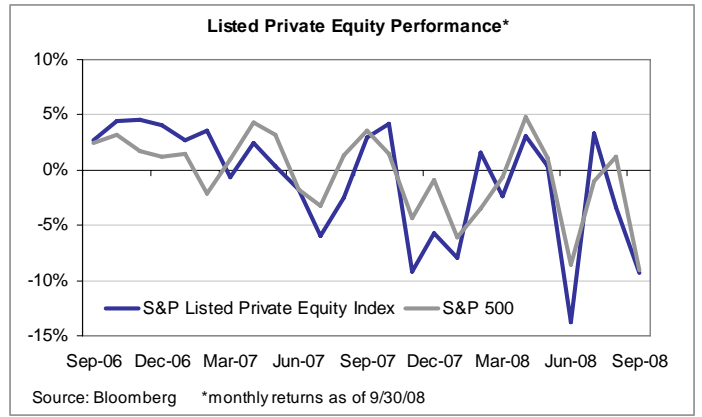
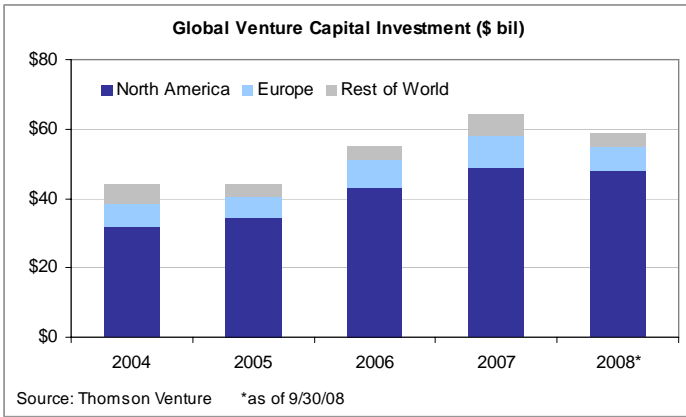
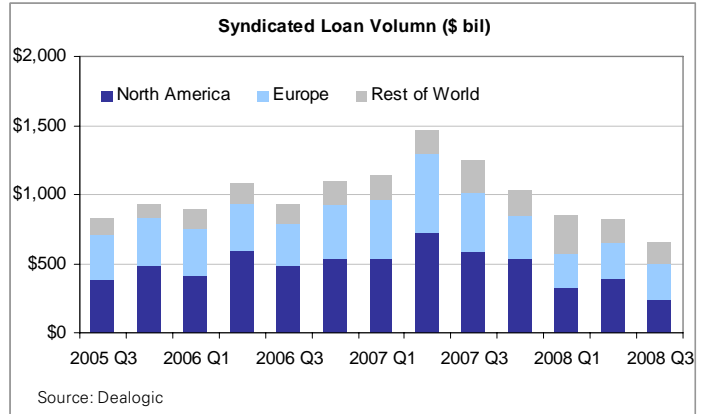
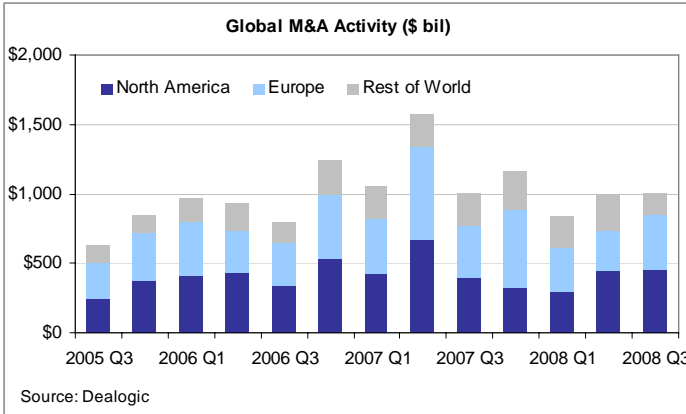
**Exhibit 5**  
**VC-Backed IPO Performance**



Source: Thomson Reuters

Given the state the economic and financial markets and its impact on private equity, what are investors to make of the current situation? Although the near-term outlook does appear pessimistic, private equity is a long-term strategy which favors patient investors. As some may recall, during the downturn of 2001-2002 a number of investors pulled out from private equity hoping to preserve capital. Nevertheless, funds raised during that period ended up producing outsized returns. Few investors would want to miss out on the next big opportunity, even if it comes at an inopportune time. The best options for riding out the current cycle are to think strategically, diversify your portfolio and choose managers based on quality, not quantity. Additionally, investors should pursue strategies that will prosper during these downtimes like secondaries, distressed debt and special situations while seeding a portfolio that will capitalize on the next cyclical upturn. Evidence shows that private equity performs at its best when faced with the worst.

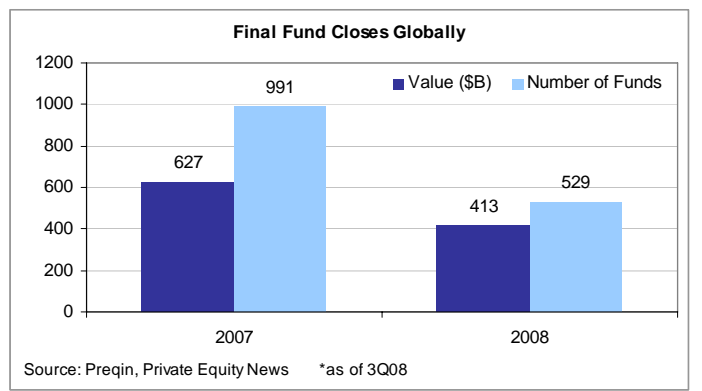
# Private Equity Trends At a Glance



### Current Private Equity Fundraising

Number of Funds on Road	US	Europe	ROW	Total
Venture	207	85	161	453
Buyout	145	65	74	284
Fund of Funds	95	57	41	193
Real Estate	198	114	115	427
Other	111	63	70	244
<b>Total</b>	<b>756</b>	<b>384</b>	<b>461</b>	<b>1,601</b>

Source: Preqin October 2008 Private Equity Spotlight



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