



Shifting sands

Limited partners' perspectives
on the future of private equity

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Summary

The Private Equity (PE) industry has been dramatically altered in recent times and looks very different now than it did only two years ago, before the financial crisis and global economic downturn.

The current downturn has not only affected the PE industry, but also Limited Partners (LPs) who invest in PE funds. To gain a deeper understanding of the current perspectives of LPs on these unusual market conditions and on the PE industry, we met with key LPs globally to ask them how they see the present PE environment and how they view the future.

The overarching view is that LPs believe the PE model is sound and that PE remains a fundamentally attractive asset class that can offer above-average returns. The PE industry will continue to grow, but 2006/2007 will be recognized as an anomalous blip in its overall growth trend.

However, there is widespread agreement that the PE model will need to change to deal with the issues, challenges and opportunities that have appeared in the past two years. This "new normality" for PE is still evolving and there is no firm consensus on what it will look like.

With that in mind, there are some common themes emerging, including:

- ▶ A return to fundamentals by the PE industry. The reliance on leverage, multiple arbitrage and continuing macroeconomic growth that characterized the industry in the years up to the financial crisis will be replaced by a greater emphasis on operational effectiveness and performance improvement to create value.
- ▶ Robust risk management functions within General Partners (GPs). It will be essential to ensure that all acquisitions are supported by a clear investment rationale that identifies value-creation opportunities, and that all investments are aligned with the GP's overall strategy. The investment rationale should be supported by strong due diligence.
- ▶ Growing importance of industry knowledge and meaningful sector expertise. GPs will be increasingly expected to have an in-depth understanding of the inherent risks and opportunities associated with the industry sectors and sub-sectors in which they invest.
- ▶ An apparent rebalancing of the relationship between LPs and GPs. LPs are becoming increasingly selective about who they partner with and are choosing to work with fewer GPs.

General market turbulence has meant that LPs have also been facing a number of issues – unrelated to the specifics of PE – that will continue to have consequences for the PE industry. As a result, LP appetite for PE has been somewhat reduced. However, this is not a reflection on the asset class. It is an indication of the extent of the impact the recession and the decline in asset values has had on allocations to PE.

The PE industry is in the midst of change. A shakeup of players is expected, as some GPs will not be able to adapt to the challenges in the market. LPs view the winning GPs' characteristics as:

- ▶ A strong investment rationale for acquisitions, supported by due diligence
- ▶ A clear strategic vision on how to improve a business that encompasses an exit strategy
- ▶ Proven operational capabilities to deliver on performance improvement opportunities identified in the investment thesis
- ▶ A strong risk management approach, with particular knowledge of the intrinsic risks of the sectors/ sub-sectors in which they are invested
- ▶ An investment portfolio that is recession resilient and that has been actively managed throughout the recession to preserve and create value such that the GP does not need to call on capital commitments
- ▶ A proven track record of generating above-average returns independent of improving markets, particularly through difficult cycles
- ▶ Recognition by banks of a good asset acquisition and asset management track record, which will make it easier to refinance existing investments and obtain additional financing for new acquisitions



The current global economic environment

Uncertainty is one of the major aspects of the global economy today, and this is reflected among the LPs. There is optimism that the rate of decline in the world economy is slowing, but no certainty as to when we may see the inflection point at which a robust and sustainable recovery begins.

Some equity markets have appeared to recover in recent months, but LPs are cautious about this heralding a general resurgence. These concerns are deepened by expectations that, despite the slowing rate of decline, many of the second- and third-order effects of recession have not yet emerged. Large corporate failures take time to work through the economic system and the effects on companies in the supply and distribution chains can take many months to become fully apparent.

Overall, there is caution about any recovery. There is a widespread expectation that downward adjustments in values are still in the pipeline and this is tempering optimism.

The PE industry is being forced to re-evaluate previously held assumptions about business models in an attempt to come to some conclusions about what the “new normality” will look like for PE.

The impact on private equity

There is unanimity among LPs that the credit crunch and the global economic recession have had – and will continue to have – a game-changing effect on the PE industry throughout the world.

The entire industry is being forced to re-evaluate previously held assumptions about business models in an attempt to come to some conclusions about what the “new normality” will look like for PE. LPs agree that the downturn will come to be seen as the crucible of this new reality, but there is no overall agreement on what this actually means. While there is a widely held expectation that 2010 and 2011 will be years of considerable opportunity, there is no consistent vision of how the industry will evolve or how things will look once the economic dust has settled and a degree of long-term stability and confidence has returned to financial markets.

These changes are being forced by a severe curtailing of leverage, as banks seek to unravel the culture of relatively easy credit that many see as one of the major factors in the current economic downturn. This sudden change, combined with the general downturn, means that PE transactions are currently scarce. Future refinancings have become increasingly uncertain, and some banks are taking direct control of PE assets that have seen their value eroded by market volatility. By restructuring finances it is hoped that some of these assets can be returned to robust valuations.

That said, it is estimated that overall, PE houses are sitting on approximately US\$1 trillion¹ in “dry powder”. While some of this may not be available for investment in the short-term, the expectation is the majority will be available for use when conditions become more benign. While these reserves signal that the industry should become more active as economic conditions ease, LPs will be watching the deployment of these funds extremely closely. They want to ensure that GPs are investing capital wisely and that long-term strategies are not forgotten in a rush to deploy funds.

¹ Source: Preqin



The effect of recession on limited partners

The economic downturn has affected LPs in different ways. Though this does not apply to the LPs we spoke with, there are suggestions that some are struggling with liquidity issues. While these have been mitigated by a lack of capital calls in recent months, the pressure has led some to reduce their level of commitments to PE.

Some LPs have been forced to reduce commitments by the denominator effect, as falling public capital markets have increased the percentage of PE in some investment portfolios and triggered selloffs by managers with strict investment allocation criteria. However, some LPs are attempting to actively manage their investment allocation to PE to counter the impact of the denominator effect on their portfolios.

These potential selloffs have led to something of a surge in interest in the secondary market, which has historically existed as a relatively small element of the wider PE industry. Most LPs think that the “fire sale” atmosphere of late 2008 to early 2009 has now dissipated.

However, evidence for recessionary effects on LPs is only anecdotal. The lack of a uniform investment allocation strategy across the LP landscape means that making generalizations about investment strategies is fraught with difficulty and any conclusions can really only be made on a case-by-case basis.

In the short-term, it is clear that overall capital available for allocation to new funds will be significantly reduced and, as a result, there is likely to be a flight to quality with LPs focusing on a smaller number of GP relationships.

Views on private equity as an equity class

There is still general agreement among LPs that PE is an attractive investment strategy that can provide superior returns to public equities. However, there is also an acknowledgment that these superior returns come with a higher degree of risk than has necessarily been acknowledged in recent years.

How this appetite for PE manifests itself will vary according to each LP, as there is no uniform approach to asset allocation. The LPs we spoke with were divided between a desire to increase and decrease exposure. The shape future investments will take may also vary, as a number of LPs are expanding their direct investment teams and sometimes reducing their indirect funding as a result.

A common theme with the majority of LPs is that the appetite for investing in new funds is limited at this time. This outlook is anticipated to remain for some time to come due to a scarcity of capital. When new funds are raised, it is likely that amounts will be smaller than those seen previously, and that there will be a focus on quality – funds that have the best history of actual and perceived performance will attract a greater percentage of the available LP capital.

There is consensus among the LPs that many investments made towards the end of 2009 and throughout 2010 and 2011 will achieve good returns, once the tipping point is reached in the global economy and recovery begins.

PE is currently in a position where optimism and focus is being placed in the medium- to long-term future, rather than the short-term. Given this forward-looking perspective, it is interesting to note that some experienced “old hands” are leaving the PE industry, which could change the dynamic of the PE asset class going forward. Time will tell on this point, but it is certainly an area of interest for LPs.



The private equity model

There is a general agreement among LPs that the PE model, while not changing entirely, will have to be altered to prosper in the post-recession new normality. However, there is a lack of clarity on what the essential elements of the successful future PE model may look like.

The most prominent change will center on the role of leverage in PE deals. As mentioned before, leverage is limited in today's market. Leverage levels will only recover slowly and are unlikely to return to the historic highs seen in the run-up to the downturn. This means that reliance on high levels of leverage, coupled with multiple arbitrage to create value, will not be a complete PE investment strategy.

The expectation is that the emphasis will continue to shift towards doing the right deals – with high-quality assets – at the right time, and improving the performance of these assets over the holding period to create value. Some GPs were felt to have lost their sense of focus and to have neglected the importance of an overall investment strategy. In the future, it is expected that successful GPs will have a more comprehensive understanding of the risks of both individual acquisitions and the impact of those acquisitions on the overall investment portfolios.

Going forward, LPs expect GPs to put more emphasis on these skills and have a coherent and robust strategy for each individual investment that can be thoroughly tested in due diligence. Each GP should have a sense of where investments fit into the overall investment plan and a strong understanding of the sector and associated risks – risk management in general is expected to be tightened up.

PE houses with proven ability to effectively implement operational improvements are expected to be the most successful when investing in underperforming and distressed assets – a route that some GPs have begun to explore.

Relationships between LPs and GPs

With the shift from the “more is better” approach to investment in the boom years leading up to the credit crunch, LPs can be expected to partner with a smaller, more exclusive selection of GPs with strong investment strategies. Discipline, a track record of success and robust investment methodologies are coming to the fore. The relationships will be closer than those seen in the run-up to the credit crunch, and information flows more significant.

This more exclusive approach is leading to a shift in the balance of power toward LPs and away from GPs, although those GPs that match these newly tightened criteria are expected to maintain a strong position and are likely to still be able to write their own terms.

Even for those GPs in a strong position, there will be pressure on the traditional 2% management fee/20% carried interest fee model. There is an expectation that the management fee, in particular, should be set at a level where it effectively reimburses cost. While many management fees are already effectively below the 2% level, there is likely to be increased pressure for further reduction. In addition, there is a consistent view among LPs that transaction fees from GPs should be offset 100% against management fees going forward.

Furthermore, the alignment between GPs and LPs became distorted in the boom years and resulted in a disparity between the risk exposure and returns being enjoyed by GPs as compared with LPs. This dislocation is no longer acceptable to LPs, who will seek to realign this gap in the post-recession environment. LPs will request partnership agreements that reflect more even treatment between the GPs and LPs.

Communication between LPs and GPs is expected to improve. Information flows had been dictated by the GPs in the boom years. The increased uncertainty of the recession has resulted in LPs requiring more frequent and detailed information to monitor portfolio performance more effectively and to identify and focus on poor performance in a timely manner.

This increased communication is a reflection of a general desire on the part of a number of LPs to see a more transparent attitude and more alignment of objectives with GPs.



Implications for the future of private equity

Not all of the current GP players in the PE industry will successfully adapt to the pressures and challenges of the current crisis or the new normality. As a result, a shakeout of the PE industry is expected.

The values of many portfolio investments have fallen and some PE houses have resorted to raising annex funds to support earlier investments. LP sentiments on annex funds vary, however. Many LPs are hesitant to capitalize annex funds without a firm understanding of the underlying portfolio and how the additional capital will be deployed.

The lack of a commercial paper market and the limited leverage in the system also continue to cause concern. This credit shortage may be intensified for weaker players as lending banks are scrutinizing historic PE fund and fund manager performance and are not extending leverage to those PE houses or managers that historically have not performed well from the lender's perspective.

Future transaction sizes are not expected to return to their 2006/2007 levels. This is also true for future fund sizes and will be the immediate situation for the next fund raising, reflecting the availability and increasing cost of leverage and LPs' own issues, rather than any disenchantment with the PE asset class.

Despite the uncertainty, there are opportunities for success. Investments made towards the end of this year and in 2010 and 2011 have the potential to offer significant returns. This is also true of investments in the secondaries market, although uncertainty over the operational performance and prospects of underlying assets means many LPs are hesitant to commit.

Some GPs have also begun to invest in distressed assets. The PE houses that will be successful in this space will be those with strong operational capabilities in addition to proven financial expertise.

Regulation of the industry is also expected, with self-regulation being the preferred approach. Many LPs want the industry – and hence GPs – to be more engaged with other stakeholders and to provide more disclosure.

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