



PRIVATE EQUITY

Heads up: what next for private equity?

ADVISORY



What next for private equity?

The private equity industry needs to take stock as a benign period of opportunity appears to have come to an end. We discuss three key issues which may indicate that the environment has become a tougher one for the private equity industry:

- i) reputation issues
- ii) the credit crunch
- iii) continual high values (to date) attached to equity investments

Private equity houses now need to reassess how they are going to make the type of returns investors took for granted three years ago. Is it action now or wait and see?

This report is the result of a series of in-depth interviews with the leaders in KPMG's Global Private Equity Group in which we gather their thoughts on the current private equity climate.

John Evans, Head of Private Equity, EMA region
David Nott, Head of Private Equity, Asia-Pacific region
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the large buyout space has been severely impacted in the short term, the mid-market buyout space is still alive throughout Europe and the U.S. and opportunities in the “traditional” emerging markets such as Latin America and in Africa – in particular South Africa and the sub-Sahara – are growing by the week. Development capital deals, which tend to be much more heavily equity-backed are, at this time, an increasingly attractive option for the private equity industry, and will make the Asian market more attractive to global houses as this type of deal is prevalent in the market. “Goldman Sachs has just raised US\$20 billion, of which around a quarter is earmarked for this region,” says David Nott, Head of Private Equity, Asia-Pacific region. “And I think the fact that the Asian region is continuing to grow in terms of wealth – and it is growing at a spectacular rate – means we will see more investment.” Additionally, the emergence of sovereign wealth funds will drive much of the dealflow at the large end of the market.

And there is a new dimension: the industry’s need to communicate to a wider set of audiences. Changes in attitudes and values are undoubtedly taking place. Asking whether we will still be using the phrase “private equity” in the latter part of 2008 seems more valid than ever. This is due not only to the media’s increased appetite to cover the industry, but also to the industry’s increased appetite to make use of the public markets. Will 2008 see many more IPOs following on from the likes of Blackstone and Fortress in 2007?

The era of certainty inside the private equity industry seems to be over. What was becoming well-trodden is now less certain. A sustained period of growth – manifested by the emergence of new and ever larger funds willing to pay higher and higher prices for assets – appears to have come to an end, at least for now. However, the attractiveness of the private equity model remains unchallenged. The incentive it provides to management teams and fund managers to create value is bound to ensure the sector grows in strength in the long term.

Overview of recent market developments

The contracting of the debt markets may be a blessing in disguise. At the very moment regulators and legislators had begun to direct their attention towards the private equity industry, the credit crunch shifted public focus away from the industry.

For much of 2007 the industry came under a sustained round of attack from trade unionists. The extent to which their message on reputation, taxation and governance got through is debatable, but the industry was taken by surprise at the strength of public debate. The personal tax returns of industry participants will certainly come back into focus, but for the moment that is off the agenda as the financial markets address the challenge

of averting a sustained crisis. Issues surrounding the reputation and governance of private equity will re-emerge, but most likely in a different form in early 2008.

The credit crunch has brought a much needed discipline to the banking marketplace. At the end of summer 2007, investment banks were saddled with unsyndicated leveraged debts totalling between US\$300 billion and US\$400 billion. The larger private equity firms accept that deals will not complete as they used to. Banks will not lend blindly and the covenants have become tighter. The remainder of 2007 may witness fewer mega buyouts than any period in the past five years.

The latter part of 2007 remains a fascinating time to be part of the industry. Although

Future Trend 1: Working within the new debt constraints

Until recently, market conditions for buyouts have been buoyant. Institutional investors have been increasing their allocation to the market, enabling private equity firms to chase larger and larger deals. Many newspaper editorials talked excitedly about the prospect of the first US\$100 billion buyout as banks fell over themselves to lend more and more for less and less.

Investment banks – desperate for a slice of the commission and fees and knowing that involvement in the mega buyouts would help them build their reputation in this market – agreed to promote deals that appeared to make little economic sense. The lenders were increasingly assuming even greater risk, with substantially greater levels of leverage available for little or no uplift in return. While liquidity was readily available, giving away some margin on funding costs was a small price to pay for generous returns. Thomson Financial research suggests that the top ten investment banks earned fees worth US\$11.5 billion for arranging loans to underpin deals during 2006.

In the competition for fees, there appeared to be a distinct risk transfer. Traditional covenants were forgone and, as with any concession, were hard to take back once given. “The debt market has felt the strain of all these transactions,” comments Don Spitzer, Head of Private Equity, Americas region.

“The structures were pretty wide open to almost anything private equity wanted,” says John Evans, Head of Private Equity, EMA region. “The competition among the banks spawned the phenomenon of debt that does not have to be repaid.”

Moreover, the banks are often putting in bridge equity, so the private equity house can re-finance a transaction after acquisition without having invested any of its own money. “But more debt does not mean more risk for the portfolio company: if they do not have to repay debt during the term, they have much more cash flow available to them to invest and to secure the business over the short to medium term,” says Oliver Tant, Global Head of Private Equity.

The private equity industry absorbed the available debt without necessarily increasing its risk. The real issue for the debt markets is whether the lenders have priced the risks they assume appropriately.

KPMG’s private equity professionals are now seeing that this favourable environment for debt finance is at an end. “Some senior business figures in the U.S. are claiming that the buyout market has peaked,” says Spitzer. “The banks have had to become more aggressive in their approach to problem debts.”

For example, one of the world’s largest private equity houses agreed to maintain a certain level of earnings before interest payments, depreciation and amortization on the senior debt in order to get away its US\$26 billion buyout of First Data – a massive concession that will reduce the return they generate on the transaction. This deal is likely to set a precedent for the coming months.

“I think the competitive environment that private equity houses are facing is quite challenging,” says Spitzer. “Probably their biggest challenge, after finding the deals that make sense, is to realize them effectively.”

While there may be a pause in the short term as the debt markets recover from their indigestion, the reality is that good and great deals will still get done in the future. There exists a huge overhang of capital sitting inside funds that can be invested over the coming years. It would not surprise the industry if the amount of equity used in individual buyouts was to increase as a total percentage of the enterprise value. This might lead to a lowering of returns in the short term but it would help the industry demonstrate its strength and ability to align the interests of investors.



Future Trend 2: The US\$100 billion buyout could still happen. Might it be an infrastructure deal?

Many of the largest buyout funds need to invest ever larger amounts to generate the returns their investors are seeking. This is one catalyst for chasing ever larger transactions and is helping to bring a more flexible approach to the definitions of what is an acceptable investment.

“Given all the money that has been available in the market, we could see a US\$100 billion buyout in the future,” says Spitzer.

“It is only a matter of time before private equity is brave enough to take on the challenge of a US\$100 billion buyout,” agrees Tant, but he points out that “recent circumstances mean the time frame is likely to be pushed back.”

Infrastructure as an asset class has emerged as a sector of interest for many private equity players in a number of mature as well as emerging markets. India is one such country, says Nott: “People are also looking at infrastructure and setting up joint ventures with Indian companies.” In April 2007, for instance, it was announced that the Indian Government-backed India Infrastructure Finance Company will be working with

a leading private equity firm on a fund which, according to its statement, could invest as much as US\$320 billion in infrastructure in India.

But Latin America and the U.S. – where significant allocations of funds have been earmarked for infrastructure investment – also have massive potential. Private equity firms are beginning to encounter a receptive audience in U.S. federal and state governments where their ambitions appear to dovetail with regional plans for economic expansion and infrastructure renewal.

Infrastructure can also offer stability and lower-risk, longer-term returns that are more attractive to institutional investors. In Canada, pension funds are keen investors in infrastructure. A number of very large funds have taken the step to invest directly in infrastructure funds – a model that looks set to be adopted in the U.S.

“The infrastructure market provides a lot of stability due to the long-term nature of the investments. In the US, the privatization of infrastructure is really beginning to hot up. The opportunities are huge”

Don Spitzer, Head of Private Equity, Americas region



Future Trend 3: Identifying potential in growth markets

"Private equity is increasingly moving east," says Tant, and is doing so at pace. According to a recent survey of 81 institutional investors by the Emerging Markets Private Equity Association, some 78 percent of Limited Partners projected that their commitments to Asia, Eastern Europe, South America and the Middle East would continue rising in the next five years. This compares with a mere 45 percent in 2004. For example, in 2002, under ten percent of U.K. private equity fundraising was for spending outside the U.K. In 2006, it was over 30 percent – and a fair proportion of that is likely to be invested in Asia.

This drift eastwards, away from developed markets, is likely to become more pronounced in the next five years, especially if economic growth rates of nearly ten percent are sustained. Some of these under-developed markets have a long way to go, it is true. While plenty of money has been raised for investment in India, deals have so far been few and far between. But this is expected to change, as Nott points out: "India is a particularly attractive market. The deals there are not big but they are strategic: they're in outsourcing, call centres, pharmaceuticals and IT."

Many of the big funds now have offices in Asia, especially in Hong Kong and Singapore (and in some cases Korea), from where they plan to invest across the whole region. "If you go back three or four years, the Asia-Pacific region was hardly on the radar screen for most of these funds; now

it is one of their priorities," says Nott. China has already assumed real significance, as the Chinese Government's acquisition of a ten percent stake in Blackstone in May 2007 so spectacularly demonstrated. "This is a milestone transaction and highlights the significance of China," comments Spitzer. The trade flows with China are already immense, so it should not be long before private equity dealflow grows in line with China's economic power. Japan might be a mature economy, but there are signs of renewed growth there too, with deal volumes doubling during 2006.

There are real opportunities for development capital across Asia, and many of them in countries which are less often discussed in the media, such as Vietnam. "In such countries, funding is much more difficult to find and the stock markets are small, yet the potential is huge: this is perfect territory for private equity to do what it does best," says Tant. It can help entrepreneurs and

small, family-owned businesses to grow and move to the next stage, especially overseas expansion within the region in order to build on existing trade links.

It is not only the emerging markets of Asia that will become significant: Africa and Eastern Europe look increasingly interesting because of the prospect of sustained, high growth. Private equity professionals in the U.S., in particular, will look more closely at Central and South America, especially Mexico, Brazil and Argentina. And one shouldn't overlook the continuing potential of core European markets either. "I think we could see a steady rise in the number of deals coming out of the German Mittelstand," says Evans. "That is what is attracting capital in Europe."

"There are great entrepreneurial companies in Asia that are crying out for expansion capital, are innovative in their markets and represent potential bolt-on acquisitions for other companies. If you've got a company in Vietnam and add one in Thailand, then one in Cambodia, then one in India and China, you'll soon have a company that covers a whole region"

David Nott, Head of Private Equity, Asia-Pacific region



Future Trend 4: Learning to manage brand and reputation

Turmoil in the debt markets in the summer of 2007 turned attention away from a period of increased scrutiny of private equity firms' operations and practises. But the issues remain and will need to be addressed by the industry. "I think one of the biggest issues private equity faces is reputation," says Tant. "If you look at the press during 2007, there has been a reaction to private equity in almost all countries as though it is a dark, sinister force."

Arguably, the industry has behaved with what can be described as naivety at best (and arrogance at worst) by not seeking

to communicate more transparently with the media, employees and the local communities in which it operates.

But Tant says the industry is turning this around: "Private equity's public relations machine is now improving, but it has struggled to keep pace with its extraordinary recent growth in economic power and importance. The days when these financial buyers only acquired small or medium-sized companies are now long behind them."

Evans says the reason the industry is coming under scrutiny is that it is

expanding and argues that it is "quite right and proper that it will continue to attract public interest".

But, if private equity does not start to deal with its image problem, governments, regulators, investor groups and stakeholders will take action. Trade unions, in particular, are hostile. Their activities may generate more heat than light, but there are important markets, such as Germany, where they have power and influence. The consequences of not investing time engaging with trade unions could mean a number of deals failing to go through.

The industry's tax environment could also be put under even more pressure across the world. "The U.S. IRS is now looking at the tax position of private equity houses, and in the U.K. the Treasury Select Committee is investigating private equity tax arrangements," observes Tant. "There have already been tax changes in Korea – where there have been some very successful private equity investments recently – China and Japan, while Australia has seen a Senate enquiry," Nott points out.

Transparency is assuming considerable importance to observers outside the industry. Tant believes increased openness would benefit the industry, in particular regarding aspects of portfolio company reporting which could be embodied in corporate governance requirements. "Private equity houses must be encouraged to say more about what they want to do, and to disclose more about the financial structures of their portfolio companies. Up until now, the industry has been highly secretive because it has had no obligation to be open."

In the U.K., the recommendations outlined by the Walker Report for greater transparency and disclosure in the Autumn of 2007 included limited interim reports and the obligation suggestion that GPs ensure reports are filed within four

months. "I think that over time the large private equity groups will come to see that it is enlightened self-interest to make their companies more transparent and arrive at that view before it is imposed on them," wrote Sir David Walker in the October 2007 edition of *Corporate Financier* magazine.

There are signs that things will change. The float of U.S. firms such as Fortress and Blackstone are the first signs that the bigger firms may not shirk from disclosing information about compensation and fees in the future.

Smaller funds are much less likely to go public, yet they should also explain their activities to the public. "You might think: what right does anyone have to look into the finances of these firms? They're private, after all. That might be true, but I think pressure from the marketplace is going to force some additional disclosure," argues Spitzer.

A number of firms – such as Europe's Bridgepoint – are responding by producing bi-annual reviews updating key stakeholders on their performance and providing important financial information as well. This is a positive step forward, which could be adopted by many more in the industry.

The industry's poor publicity should be put in context. "For the most part, it has a good story to tell because it is a constructive commercial infrastructure interested in the development of successful and thriving businesses," argues Tant. "It often takes over struggling businesses, turns them around and creates more jobs. This needs to be pointed out because private equity does not make money simply by financial engineering and by stripping out costs."

Communicating the value they add – and for whose benefit – is something private equity firms have now started to take more seriously. "The private equity community has got into overdrive now, aiming to

indicate how it has increased employment, turned companies around and grown sales," says Nott. "They're taking companies offshore and making them viable. I hope we'll be seeing lots of good news stories about how private equity has developed companies."

Private equity methods to generate high returns are in no way sinister or contrary to the interests of the stakeholders in portfolio companies. Institutional investors in private equity funds, the overwhelming majority of which are pension funds and life assurance companies, are the main beneficiaries – not, contrary to the media-portrayed image, an elite group of super-rich people. Many of the largest investors in private equity funds in the U.S., for instance, are public sector funds such as the California Public Employees Retirement System. "The remuneration of private equity professionals themselves is a diversion: this issue should not be driving the public agenda as it is now," argues Tant. And as Evans says: "Unfortunately, the only thing the public understands now is that the industry's professionals are being paid very well for what they do."

THE END OF "PRIVATE" EQUITY?

The debt crisis, reputational troubles and post-flotation stock price plunges by Blackstone and Fortress have led people to ask whether private equity has had its peak. One of the casualties might, in time, be the very term "private equity", which could be seen as inferring a certain desire to be secret. "The word 'private' may be a casualty of the spate of negative publicity," suggests Tant.

But the more immediate effect is that the membership of industry bodies such as the European Venture Capital Association is encouraging a split of the industry into three component parts: a large, leveraged buyout group; a middle-market group; and a venture capital segment. "I think more people will want to align themselves with the venture capital end of the industry and be associated with the dynamics that exist at that end of the spectrum rather than with the leveraged buyout segment," says Tant. The market is certainly segmenting. "Already you can see very clear tracks towards an environment of mega-global funds and the mega funds that are perhaps not global but at a regional level," says Evans. "You can also see some very clear segmentation in the rest of the market."



Conclusion: The challenge for private equity now

The success of the private equity model has fathered the issues facing the industry today. Fundraising and deal-size records have been smashed on a regular basis and the industry has finally emerged from the shadows to take its place in the financial markets, albeit with the spotlight on its actions. There should be limited surprise that it has attracted scrutiny from regulators, envious attention from the public and, in a few countries, something of a backlash from tax authorities and trade unions.

The onus is now on private equity to explain how – and to whose benefit – it has generated such excellent returns,

to showcase its achievements and to justify its rewards. It is in the interests of the global economy, and of millions of pension fund investors, that it does so. This process might involve the breaking up of the industry into its three constituent parts, as discussed opposite, in order to highlight its different skills.

Although much attention has been focused on the megadeals of big buyout firms, it is the lower- and mid-market transactions where the bulk of private equity activity occurs. Returns from these investments will remain robust, not least because debt-to-equity ratios

of mid-market companies are lower than the ones seen with larger deals.

It is still uncertain what trends will emerge in the arena of debt, although it is likely that banks will revert to a more cautious approach to lending in the near term. The high levels of leverage of the past couple of years are unlikely to be tolerated and the consequent cooling off of dealflow at the leveraged buyout end of the market should provide time for the industry to step back and assess its priorities for 2008. There is no doubt that deals will still be done and that, after a period of hesitation and house-keeping in the debt market, the larger end of the deal market will return.

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