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How to remain a top performing Private Equity firm during the global economic crisis

John Romeo, Partner in Oliver Wyman, says the global economic crisis is having a profound impact on all segments of the financial services landscape, with significant implications for market participants and stakeholders. Indeed, the alternatives sector, broadly defined faces many stern challenges. Hedge funds are likely to be first in the firing line given performance, redemptions, high water marks and weak prospects for broader fee level sustainability. By contrast, Private Equity (PE) firms will be more insulated as a result of lock-in periods and a diversity of investment styles. To avoid adverse consequences in the medium-term, however, three things need to be at the top of PE firms' agenda. Firstly, firms need to identify how to remain in the deal flow: Limited Partner (LP) investors will take note of who is not involved in the fewer transactions that do occur. Secondly, firms must reassess their existing portfolios and focus on de-leveraging historic investments where necessary: write downs will critically handicap future fund raising efforts and open the door to fee reductions on new funds. Thirdly, firms need to re-consider their core business models to remain relevant to LPs amidst the changing market landscape.

Deal flow: Hunt for deals in the right places

Recent events have led to a market where leverage is virtually non-existent and have punished those who sought to call the bottom early. Within financial services, wholesale funded businesses and commercial real estate are currently viewed as radioactive, and most firms simply will not evaluate balance sheet businesses. Even the market infrastructure/plumbing businesses, previously seen as stable investments, have had serious concerns raised about their business models and the impact of inevitable regulatory changes.

Looking beyond the next few months to when the dust has settled and the degree of market nationalisation has hopefully become clearer, there will be significant opportunities for PE firms with “dry powder” to pick up mis-priced assets as well as disposals from financial institutions, including those in distress and cast-offs from the accelerated wave of consolidation. We view financial services as a particularly attractive segment given changing dynamics, market distress and lower leverage requirements.

Five areas in particular have a high likelihood for providing good investment opportunities:

1. Financial asset acquisition

The lack of liquidity in the market for financial assets presents attractive acquisition opportunities for informed real money buyers. Many of the complex assets on balance sheets are poorly understood and, as a result, frozen. Investors with fundamental primary market knowledge or unique channels to access information have an advantage, given their understanding of the value of these assets. Whilst most of the assets will be un-leveraged, making it difficult to achieve 40%+ Internal Rate of Return, we believe 20% should be achievable in many instances for a very favourable risk profile and limited downside.

2. Insurance

Beyond the US and a few isolated European examples, insurance has largely escaped the crisis. Whilst it is true that almost everyone has exposure to AIG or Lehman, and equity market weakness and a global recession are not good news for life

insurers, when compared to other sectors, the situation is better than it may appear at first glance. Large European insurers sense a shift in the balance of power and are looking to cement this on the ground, but opportunities far outweigh their available capital. There is an obvious opportunity for PE firms, alone and in partnership with strategics, to play a more front-and-centre role in picking insurance assets from banks that are not yet deeply distressed and acting as warehouses for additional assets of interest to other strategics.

3. Wealth management

Firms should be nervous about acquiring retail-orientated fixed income asset managers, because these assets are likely to be substituted for deposits. Even equity players, which on the surface appear to offer value, are being hit by high redemptions and may be damaged for some time to come given that risk appetite may have permanently changed.

As clients run for cover there is growing appreciation of the value of advice and increased recognition that they cannot manage the portfolios themselves in times of stress – witness recent hiring announcements by Deutsche Bank and Credit Suisse. As a result, we see opportunities principally in the private banking space as numerous bank/insurers are in the process of divesting their private banks. Given the lack of debt, achieving target returns on a pure equity basis in this area will require a generation of substantial earnings growth from a combination of rigorous cost efficiency and medium-term revenue growth.

4. Infrastructure, advisory and transaction processing

Many private equity firms will seek to avoid exposure to rapidly fluctuating financial asset values, but will seek to benefit from trends in financial services through low balance sheet businesses such as advisory boutiques; brokerages; transaction services providers and Fin-Tech companies, to name but a few. Many firms in this sector have seen strong declines in their stock or, for those owned by banking groups, even stronger decline on the parent's stock. Some impact, given market structure and regulatory concerns, is to be expected. For those impacted disproportionately or others concerned about the stability of their parent/shareholder base, it will drive management appetite for both public to private and carve-out deals.

5. De novo balance sheet plays

PE firms, in concert with strong, proven management teams, have an opportunity to build new businesses. Whilst this applies broadly, it is most compelling in the balance sheet space which avoids taking on legacy problems.

Valuation levels are likely to return to more 'normal' levels in the medium-term, making 2009/2010 an attractive investment environment. Achieving good returns will depend on post-transaction value creation, requiring strong sector and operational focus. Investment committees will not be comfortable basing investment decisions solely on financial engineering.

Existing portfolio: Selectively de-leverage what you have

Managing legacy investments across all sectors should be a top priority and will require increased hands-on management and many difficult decisions. PE firms need to understand the impact of reduced earnings before interest, taxes, depreciation and amortization (EBITDA) in a recessionary environment on portfolio companies, particularly those deploying significant leverage. Some investments may require special attention. Others may now appear to be attractive opportunities to deploy capital, where PE firms want to substitute equity for debt.

Portfolio companies with potential cash flow shortfalls (that could impact their ability to pay down debt in a timely manner) as well as those PE firms which are expected to tap into debt markets (again to refinance bank loans and high yield bonds) demand attention. It is critical that managers concentrate on de-leveraging these portfolio investments. This is indeed a significant industry issue, since among the different PE types (i.e. venture, growth and buyout) buyouts garnered more than 75% of PE capital over the past five years, the bulk of which was skewed toward highly leveraged transactions. No-covenant and covenant-light financing, which dominate recent capital structures makes this less time sensitive; however, the clock is ticking and a low return is infinitely superior to a complete loss of capital.

PE firms should pursue a systematic approach to de-leveraging that balances the interests and expectations of existing LP investors with those of the General Partner (GP). To that end, we expect that PE firms will consider the following four prioritised ways to reduce portfolio company leverage: restructure debt, inject capital, dilute equity and sell non-core assets.

1. Restructure debt

Restructuring debt before covenants are breached, loans become due or bonds are called/redeemed may improve a PE firm's ability to secure more reasonable debt terms and pricing for a portfolio company. While PE firms may need to allow time for markets to stabilise, a top priority should be replacing bank loans that were previously packaged into collateralised debt obligations (CDOs) and are therefore unlikely to be available in the future. With high

yield market issuance characteristically thin amidst increasing market levels of distressed debt, this task will not be easy. Potential options include direct debt investments from existing LPs or other outside institutional investors, sovereign wealth funds and hedge funds.

2. Inject capital

A second technique that firms can use to reduce a company's leverage is to inject capital, either through additional fund investment (clearly this is only available to firms with "dry powder") or through existing LP co-investments, likely on a no fees, no carry basis. This approach can be accomplished in two ways. The first way is for PE firms to contribute capital directly to a portfolio company to retire debt. This will lower overall fund returns, however, and GPs will need to gain the trust of their LPs to ensure a successful capital call. An alternative way would be for firms to invest capital indirectly by repurchasing debt in the secondary markets. In the current environment debt values are likely to be significantly below face value (e.g. 75-85 cents on the dollar), which is likely to make this approach financially superior.

3. Dilute equity

A third option is to dilute equity by introducing additional equity investors. Whereas downrounds are an unwelcome but common fixture in the world of venture capital, leveraged buyout investors expect that a target's cash flow will be sufficient to retire debt without the need for further equity investment, particularly at a valuation unfavourable to existing investors. Despite challenges with investor expectations, raising new money from other PE firms may prove an expedient solution for retiring debt, provided that the target company's future prospects are sufficiently attractive post-investment.

4. Sell non-core assets

Selling non-core assets is the fourth way to free-up valuable capital. Several considerations for determining the viability of this tactic include the following:

- How large is a potential transaction in relation to the level of effort required to close it? The opportunity cost of small deals may be too high with respect to management time and focus.
- How integrated are the assets in question within the larger firm? Firms must weigh the cost, time and effort of replacing valuable capabilities and functionality lost in a divestiture against the potential for gain.

- What are the tradeoffs between de-leveraging and lower EBITDA following an asset sale? If the loss of cash flow is too great, coverage ratios may not improve and could be potentially worse after an asset sale.
- Finally, are market conditions favourable for a sale? Selling when conditions are poor is likely to result in an inferior price, increase the likelihood of a failed transaction and communicate a level of duress to the market, which may have unwelcome and unintended consequences such as a ratings downgrade.

For the foreseeable future, options for reducing portfolio company leverage are expected to be painfully constrained and firms will likely need to employ a combination of each of these techniques to avert disaster.

Business model: Position to remain relevant

LPs are expected to shift asset allocations in light of revised judgments about the future prospects of different asset classes, triggering a medium-term shakeout in the competitive landscape. In order to compete for fresh funding, firms must consider which asset classes and strategies are likely to thrive in the new market conditions, and how they can continue to achieve top quartile performance. Over the medium-term, successful PE firms will take three actions to position themselves to remain relevant.

1. Play to the shifting LP mindset

Risks and returns of future strategies are expected to differ significantly from those of the recent past. Facing greater volatility and often lower returns, sophisticated LPs will increase their focus on risk-adjusted vs. absolute returns. This shift is expected to have a significant impact on institutions' future capital allocations to the various asset classes, which will affect PE firms differently, depending upon their business model. Successful PE firms will analyse their performance on a risk-adjusted basis, helping LPs to understand their superior value proposition in a way consistent with LP capital allocation models. As a consequence, assets will continue to concentrate among leading players. Over the medium-term, competition among LPs for access to top performing firms is likely to spare them from fee compression. Firms that have stumbled but remain in the game will likely need to reduce their management fees to raise new money.

2. Select a suitable model to compete

PE firms need to understand and exploit their competitive advantages by focusing on a specific business model, specialised or diversified, that best fits their capabilities. Specialisation could be by investment sector or stage, while a diversified model encompasses multiple asset classes (e.g. PE, hedge funds, distressed assets/debt, project finance, advisory, long-only, real estate, etc). Both can be successful; however, the choice has profound implications for firms' target LP base, fund sizes and scopes, investment types and sizes, returns and volatility, human capital and required infrastructure.

Successful firms focusing on sector specialisation will possess deep insights into highly complex or technologically sophisticated businesses in sectors such as energy, technology and healthcare. In addition, they are likely to have a secondary focus on stage such as VC or buyout in order to consider a full range of opportunities that leverage their core competencies. Similarly, top performing firms that are pursuing a stage specialisation model will concentrate foremost on VC, growth or buyout (and within buyout un-leveraged, mid-market or large deals) and seek to grow assets under management through expansion into new sectors.

Whilst more complex, the diversified model has the potential to increase firms' "sweet spot" to the benefit of GPs. Given that institutions' investments are nearly always in particular funds rather than a management company itself, asset class performance will continue to be vital, requiring diversified firms to specialise within each asset class as well to compete effectively.

3. Develop robust and pragmatic methods of operation

Model choice will dictate the required level of infrastructure and operational sophistication. Clearly, small, sector-focused VC firms require a different approach than growth and buyout-orientated firms. Across all models however, the current market environment, underpinned by the structural trend toward institutionalisation of the PE industry, will force changes in firms' investment decision process; from evaluating the financials of individual deals, to the focus of due diligence efforts, to the makeup and functioning of the investment committee.

More specifically, PE firms will need to increase the granularity of financial stress testing of prospective investments (earnings, working capital, solvency), not least as a result of the reduced options for dealing with investments that are close to a covenant breach. Firms will also need to standardise investment return projections (including analysis of both upside and downside cases) to allow work in progress to be compared on an apples-to-apples basis. As a result, the emphasis on due diligence activities will shift towards downside mitigants (e.g. the effectiveness of the enterprise risk management function). Finally, PE firms will need to revisit the structure and constituents of the investment committee to reflect changes in the market place and to manage potential conflicts of interest.

These are unprecedented times. The opportunity set evolves week by week with numerous challenges in keeping track of asset ownership and decision makers as well as considering the impact of greater government and regulatory intervention. There is significant opportunity for Private Equity to play a critical role in reshaping the market landscape; however, as in any market dislocation, there will be winners and losers. The winners will be those firms that create a differentiated angle on investment opportunities, deliver value to the existing portfolio and develop appropriately robust business models.

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