

Mapping the recovery

New strategies for private-equity markets

A report from the Economist Intelligence Unit



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Introduction

With the financial crisis continuing to wreak havoc in many of the world's economies, access to capital is becoming harder and dearer. Despite heavy injections of liquidity from governments, lending has slowed to a trickle across most industries and markets. Bankers' reluctance to offer finance stems from widespread uncertainty about the length, intensity and consequences of the current crisis. This poses significant challenges to the private-equity industry, which has enjoyed unprecedented growth over the past decade thanks partly to unfettered access to cheap credit. Private-equity firms are likely to feel the impact of tighter lending terms both at the level of their deal flow, and in their ability to manage the companies they have acquired. This is a market context that will require discipline, judicious planning and innovation from private-equity practitioners if they are to survive the financial crunch and emerge stronger.

In order to assess the outlook for private-equity markets, and to identify the strategies private-equity firms are likely to pursue to weather the economic downturn, the Economist Intelligence Unit surveyed 222 executives from this industry in September-October 2008.

About the survey

The Economist Intelligence Unit surveyed 222 private-equity professionals in September-October 2008. The survey, sponsored by Celerant Consulting, covered selected markets in North America and western Europe, including the United States, United Kingdom, Germany and France, with Scandinavia and the Benelux countries also represented. Over one-third of respondents were at the level of

partner or managing partner, and another one-fifth were directors or vice-presidents. There was also a balance in the sample between larger and smaller private-equity firms: nearly half (46%) had assets under management of US\$500m or more, while one-third had assets of under US\$250m.

Our editorial team executed the survey and conducted the analysis. Andrei Postelnicu wrote the report. The findings expressed in this summary do not necessarily reflect those of the sponsor. Our thanks are due to the survey respondents for their time and insight.



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Key findings

Following are the main findings to emerge from the research.

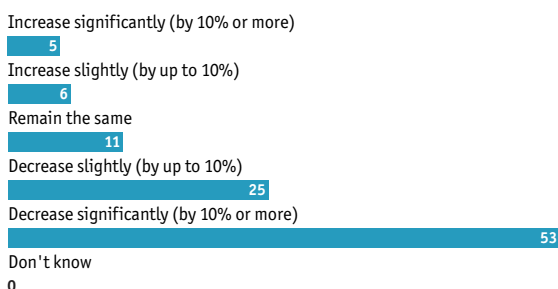
Expect no early recovery of private-equity markets. There is an emerging consensus amongst economists that the duration of the current credit squeeze will extend years rather than months. The adjustments required throughout the financial-services industry are widely seen as dramatic and complex—and will require time to implement. Private-equity professionals provide a correspondingly sober assessment of the outlook for their industry. An overwhelming majority of respondents (73%) see no recovery in private-equity business levels before the first half of 2010, although a brave 23% believe a full recovery will come before the end of 2009. Europeans, notably German and French respondents, are more sombre in outlook than their American peers.

Almost all industry executives expect there will be fewer deals over the next year, and most believe that these will be of considerably less value than previously. The boom years were characterised by “too much money chasing too few good ideas”. In a downturn, by contrast, even worthy ideas find it hard to obtain financial backing. Until the recovery does occur, most private-equity professionals expect to be more conservative with both the value and the volume of their deal flow. Significant declines of at least 10% in the value of the deals are expected by 60% of respondents. More than half similarly expect the volume of the deals to fall by at least a tenth, if not more.

Readiness for change, but in what direction? Given the breadth and depth of the current crisis, root-and-branch reform of the entire financial-services sector is clearly on the cards. The private-equity industry is no exception, and our survey points to an awareness of the industry’s need to re-examine

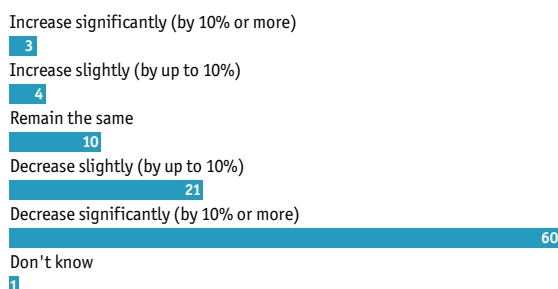
How do you expect the volume of PE deals to change over the next 12 months? It will...

(% respondents)



How do you expect the total value of PE deals to change over the next 12 months? It will...

(% respondents)





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itself, even if it has not yet reached any definite conclusions as a result of that process. Consolidation of private-equity firms is clearly one expected consequence of the crisis, but industry executives are just as clear that financing models will have to change appreciably. In the current environment the vast majority (three-quarters) of our respondents plan to increase the equity/debt ratio of their deals, although no more than one-third are ready to make acquisitions in the current climate without securing debt facilities at all.

In the meantime, the private-equity professionals surveyed show no pressing need to complete transactions in this climate. Two-thirds of respondents are prepared to hold off on investments in the expectation of more attractive deals materialising in the future. Buyouts will be less frequent. And many private-equity firms will intervene more closely in the companies in their portfolio (of which, more later). An unappealing option for most firms, in light of tougher access to capital during the squeeze, is relinquishing the capital already on the books: less than one-third of respondents are prepared to return money to investors in the present environment. (Although there are geographic distinctions: half of UK-based respondents are prepared to give money back to investors, nearly twice as large as the share of respondents in the US who say the same, and five times that in Germany.)

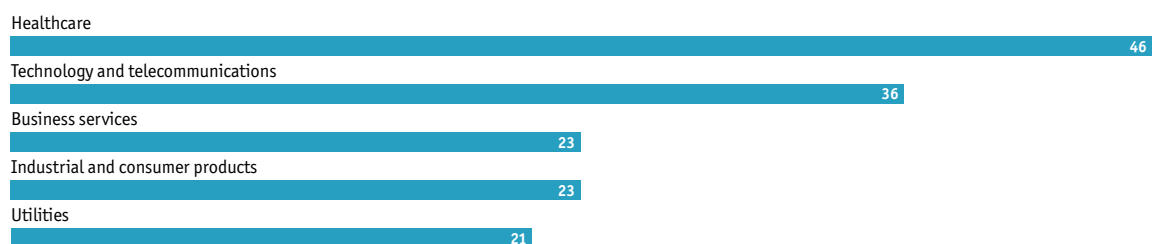
There is some taste for adventure. When it comes to choosing investment targets, traditional strategies are likely to remain the norm for most private-equity firms during the downturn. Nonetheless, a significant minority of surveyed firms display an appetite for adventure—even assuming a reduced number of deals. More than 40% of respondents are inclined to venture outside their comfort zone in terms of sector (44%), geography (45%) or size range (42%). Of the sectors likely to attract investments from private-equity firms, healthcare tops the list for almost half of respondents, a likely reflection of its growth potential irrespective of economic cycles. IT and telecommunications likewise retains its attractiveness compared to other sectors, suggesting an expectation that web-based services will continue to be developed irrespective of the downturn, and that network upgrade plans will be revived once it ends.

Wherever they venture, private-equity firms can expect tougher competition in landing the more attractive investments from funds with high levels of liquidity. Most notable amongst these are sovereign-wealth funds. With billions of dollars of liquidity, time to spare and the widest latitude for deploying

With ample liquidity and wide latitude for deploying their capital, sovereign-wealth funds have emerged as the top competitor to the private-equity sector.

If you were to invest in or acquire private businesses over the next 12 months, in which of the following sectors would you put your money?

(Top responses; % respondents)





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their capital, sovereign-wealth funds have emerged as the top competitor to the private-equity sector, according to 32% of survey respondents.

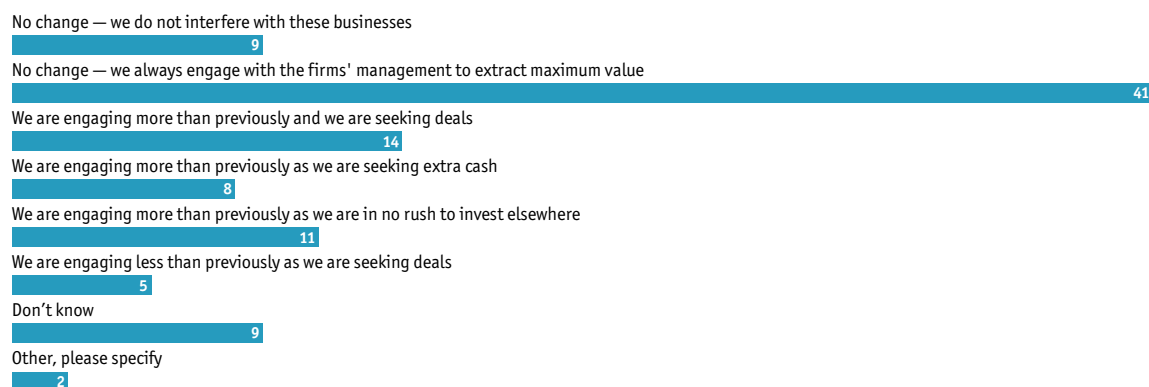
All eyes on the portfolio. As mentioned earlier, a large number of private-equity executives plan to take a more hands-on approach to the management of their portfolio companies than had previously been the case. The purpose, of course, is to increase the value of each investment prior to exit. For the largest share of executives in the survey, the firm's management approach will not change—41% say they always engage closely with the management of portfolio firms to extract maximum value. But another 33% plan to engage more closely than they have, whether it is because they simply have more time to spend in advising portfolio firms, they are seeking extra cash due to the firms' performance or due to some other objective.

The need for such engagement becomes clear when industry executives offer their views on the reasons behind the under-performance of businesses in their portfolios. Far and away the chief contributor to poor performance is the failure, to one degree or another, of the management teams of invested firms. Secondary factors that could derail a successful investment are a by-product of ineffective management: a lack of focus and integration plans that are not executed to the full.

A buyer's market for private-equity recruitment. Before the crunch, private equity represented the Holy Grail for many financial-services professionals, alongside hedge funds. In the wake of the credit squeeze, however, the majority of private-equity firms will not surprisingly be more cautious in hiring. Little more than one-quarter of respondents (26%) say they plan to increase the hiring of private-equity professionals in the current environment. Those that will land new jobs are far more likely to be operational specialists than financial analysts or investment professionals, likely reflecting private-equity firms' intention to become more involved in the day-to-day management of portfolio firms.

When it comes to realising and increasing an investment's value prior to exit, how—if at all—has your firm's approach to its portfolio companies changed since the onset of the credit squeeze?

(% respondents)





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Conclusion

A renewed focus on maximising the value of investments through better management may prove the silver lining in the cloud that is enveloping the private-equity industry.

For the private-equity industry, the coming months and years are likely to be one of retrenchment, rather than the fundamental restructuring which awaits the banking sector. Many—though far from all—private-equity firms retain hefty reserves of cash, but tighter and more expensive access to credit will hamper deal-making across most sectors. And as the financial crisis which originated in the developed world extends to the rest of the globe, hopes that private-equity firms will be able to significantly ramp up deal-making in emerging markets may prove elusive.

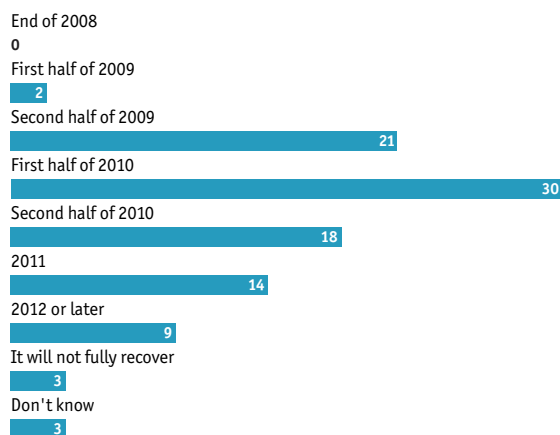
Our research suggests that industry executives are taking a pragmatic approach to the challenges emanating from the economic crisis: deal-making activity and volumes will be less, but firms will be on the lookout opportunistically for investments, which fit their parameters, in favoured sectors. Longer term change will be sought in how firms structure the financing of deals, but in the meantime, private-equity firms will seek to bolster the performance of the firms in their portfolio—in large part through more involvement their day-to-day management and provision of advice. A renewed focus on maximising the value of investments through better management may prove the silver lining in the cloud that is enveloping the private-equity industry.

Appendix

The Economist Intelligence Unit surveyed 222 senior executives of private-equity firms in North America and Europe September–October 2008 on the challenges facing the private-equity industry. Please note that not all answers add up to 100%, because of rounding or because respondents were able to provide multiple answers to some questions.

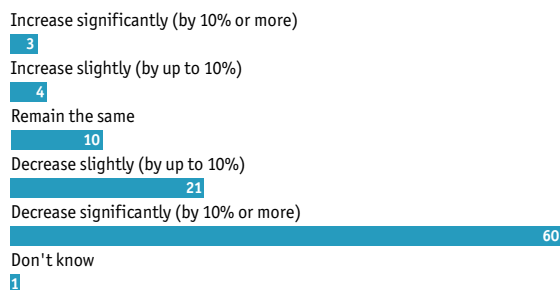
By when do you think the PE market will have fully recovered from the effects of the economic downturn?

(% respondents)



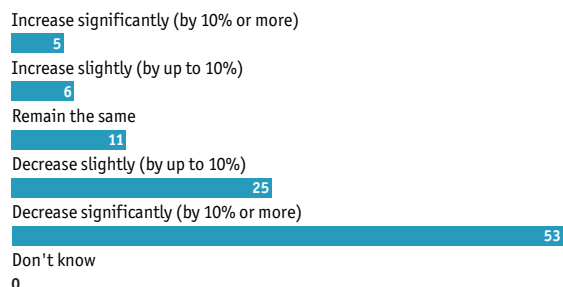
How do you expect the total value of PE deals to change over the next 12 months? It will...

(% respondents)



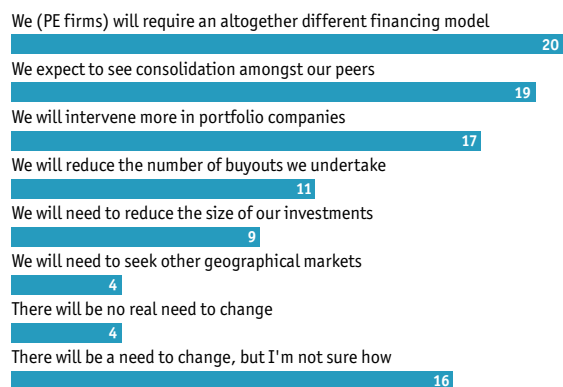
How do you expect the volume of PE deals to change over the next 12 months? It will...

(% respondents)



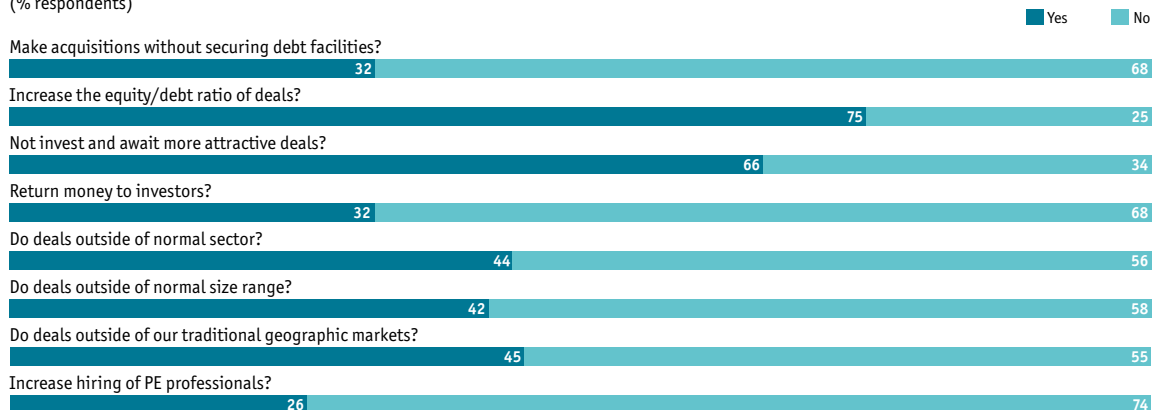
Which of the following statements best reflects your view of how PE firms in general will need to change following the credit squeeze?

(% respondents)



Given current economic circumstances, are you prepared to:

(% respondents)



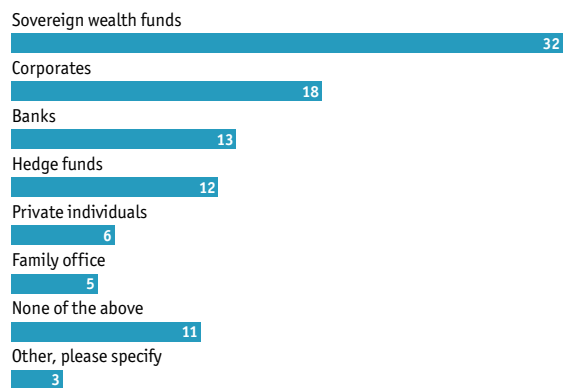
Which of the following is the highest priority category of PE professional that you will seek to recruit over the next year?

(% respondents)



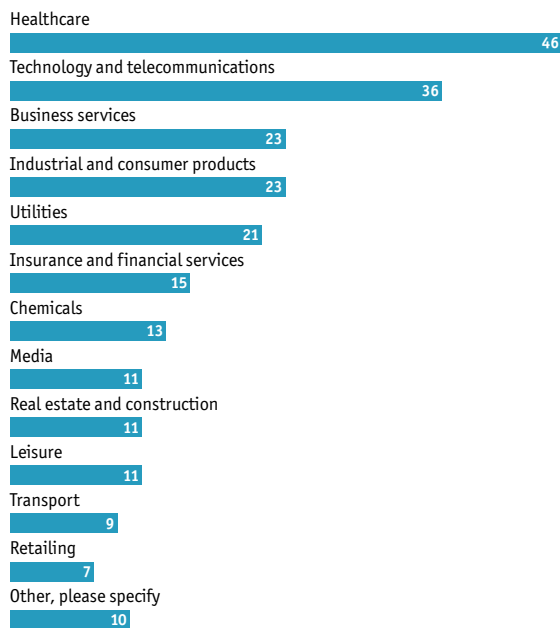
Which of the following sources of finance pose a greater competitive threat to PE companies since the beginning of the credit squeeze?

(% respondents)



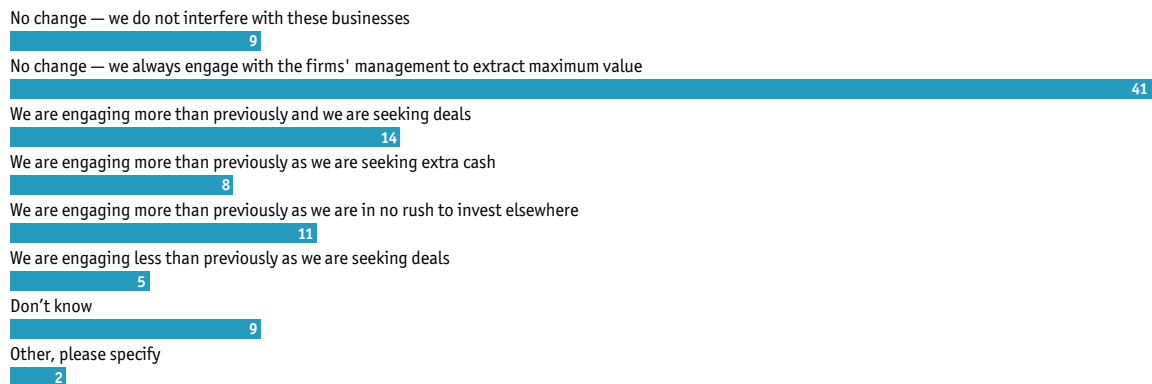
If you were to invest in or acquire private businesses over the next 12 months, in which of the following sectors would you put your money? Please select up to three.

(% respondents)



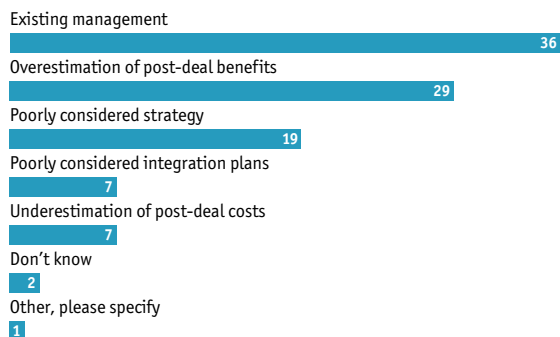
When it comes to realising and increasing an investment's value prior to exit, how—if at all—has your firm's approach to its portfolio companies changed since the onset of the credit squeeze?

(% respondents)



In your experience, which of the following is the most important pre-deal factor in under-performing businesses?

(% respondents)



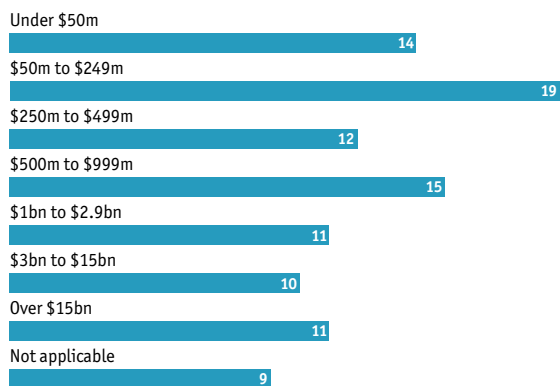
In your experience, which of the following is the most important post-deal factor in under-performing businesses?

(% respondents)



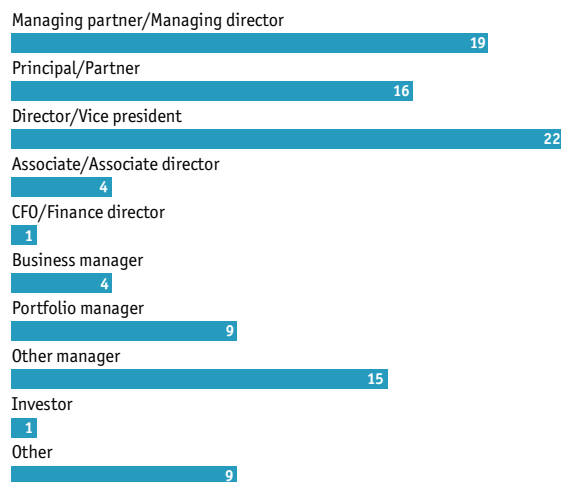
What assets does your organisation have under management in US dollars?

(% respondents)

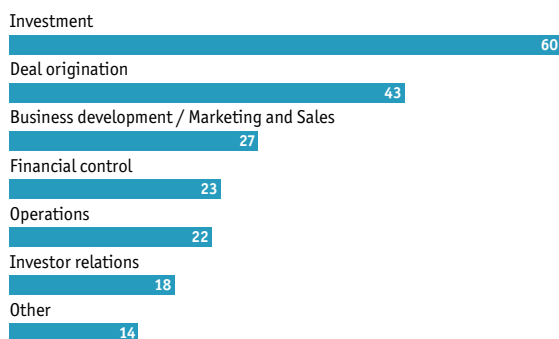


Which of the following best describes your title?

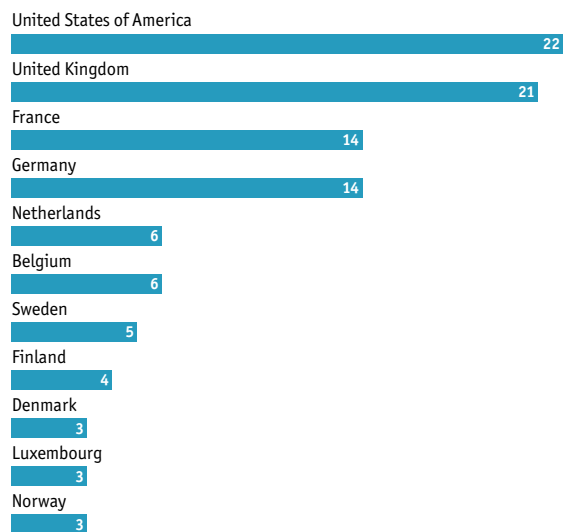
(% respondents)



What are your main functional roles? Please choose no more than three functions.
(% respondents)



In which country are you personally located?
(% respondents)



About the sponsor

Celerant Consulting is an international consulting firm that specialises in operational transformation. The essence of Celerant's approach is that its consultants work side-by-side with people in the front lines of business from the boardroom to the shop floor to

ensure the delivery of sustainable and measurable benefits. Celerant embeds long-term behavioural change into the culture of its clients organisations using a unique approach called Closework®. Over the last 20 years Celerant has become the largest independent firm of business operations consultants, with annual revenues of over €110/\$170m in 2007.

Whilst every effort has been taken to verify the accuracy of this information, neither The Economist Intelligence Unit Ltd. nor the sponsor of this report can accept any responsibility or liability for reliance by any person on this white paper or any of the information, opinions or conclusions set out in the white paper.

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