

TOP OF THE CLASS

Private equity returns will be big in 2010, writes *Kirk Radke*. The author is *World Finance's* leading individual lawyer in the US for 2010

The pace of change in today's financial markets is unparalleled. Things have changed fast and dramatically; all of the world's markets have been affected.

In 2010, these changes will continue to create unprecedented opportunities for the strongest private equity firms around the world.

A year ago, the financial markets were in crisis, in some instances all but frozen. In this environment, the focus for a private equity firm was on its existing portfolio of investments; exploring new investments was not high on the agenda in most executive suites.

Beginning in the early spring of 2009, dealmakers began to shake off this bunker mentality; at those firms with sources of liquidity (or "dry powder" from investors) and relatively healthy portfolio companies, dealmakers felt reasonably secure. By mid-summer, the strongest firms began to consider investment opportunities.

Deal momentum increased in the fall of 2009 and will continue in 2010, propelled by five market forces.

First, private equity firms have over USD 500bn of "dry powder," or capital commitments from their limited partners, for new deals. This is committed money; no new investment decisions have to be made by any limited partners. The average remaining life of these commitments is less than three years. If these commitments are not invested in this period, they will expire, thereby creating an additional incentive for private equity firms to find new investments. So, the supply of risk equity capital is poised for investment. If one applies modest leverage multiples to this aggregate USD 500bn

of capital, e.g., five times leverage, the aggregate deal activity generated from private equity firms will be over USD 3trn.

Second, private equity firms are organized to respond quickly to change. These firms are not bureaucratic; senior management at these firms have the experience, knowledge and information to be comfortable and confident in taking decisive action in risky, uncertain environments. In many ways, these firms' confidence in their decision making approach has been reinforced by their ability to navigate successfully the financial markets over the past couple of years. They have the confidence and appetite for new investments. The present environment of accelerated change will reward the structure of these firms and the skills of their executives.

Third, private equity investors have demonstrated to all market participants that the highest historical returns have been generated from investments made in the period immediately following a recession's trough. The private equity returns for the 1992–1994 period (following the 1990–1991 recession) and the 2002–2004 period (following the 2001 recession) are widely recognised as being the best private equity vintage years, generating the best returns. While one can debate whether this historical pattern will apply to this recession, it is nonetheless a fact which will influence dealmakers around the globe – they will ask themselves can they afford to sit on the sidelines during 2010, potentially conceding to their competitors a record vintage year of returns? They will ask themselves, "isn't now the time to invest?"

Fourth, private equity firms are now global in their scale, reach and investment focus. In the previous two cycles, the private equity opportunities were limited to US and Western Europe. In this cycle, opportunities in each region of the world will be considered; the best investments in this cycle may well not be in the US and Western Europe. Private equity firms are positioned to take advantage of investment opportunities wherever they arise.

Fifth, the existing portfolio companies of private equity firms will be an extraordinary source of deal activity. These firms are facing a refinancing "wall" from the debt incurred in the 2006–2007 peak of private equity investing. In the United States alone, these portfolio companies have nearly USD 1trn of debt that will be due between 2010 and 2014. As private equity firms attempt to refinance the debt of their portfolio companies, they will engage in all types of deals – ranging from selling a business (or certain of its divisions) to strategic buyers or other private equity firms, to IPOs, to, in some circumstances, restructurings. Such restructurings will generate their own deal activity including "debt M&A"; debt M&A is a tactic which emerged in 2009 in restructurings in the US and Europe in which a firm acquired control of a target by purchasing the target's debt and converting such debt into equity control of the target in a restructuring proceeding. Market participants recognise that the private equity owners of these firms will be creative and tenacious in their refinancing, and they will not wait. They will focus on this refinancing task in 2010, generating significant deal activity in the process.

USD 3trn

AGGREGATE DEAL ACTIVITY GENERATED FROM PRIVATE EQUITY FIRMS

USD 1trn

DEBT OF US PRIVATE EQUITY FIRMS THAT WILL BECOME DUE
BETWEEN 2010 AND 2014

2010 may also be a watershed year for the private equity industry as more and more key governmental and influential economic decision makers realise private equity's positive place in today's financial markets. After sifting through the results of the last couple of years, analysing the events and aftermath caused by all of the market turmoil and changes, policy makers and investors alike will be left with the following four key observations:

» Private equity did not cause the systemic risk which shook the foundation of the world's financial markets in 2008. The decisions made by private equity firms and the investments they made did not contribute to this meltdown in the financial markets.

» Private equity promotes economic growth. Academic research made public in late 2009 has demonstrated that industries in which private equity has invested have exhibited significantly more growth than industries in which private equity has not invested. Additionally, market participants have observed in 2009 many examples of how private equity firms, by working closely with a portfolio company's executives have improved such company's performance even in today's difficult economic climate.

» Private equity is a better corporate governance model than the typical public company model. In a private equity company, there is no disconnection between a company's management and the company's owners, the agent/principal problem which economists have widely noted exists in a public company. In a private equity company, the owner of the company - the private equity firm - sits in the boardroom and works closely with the company's man-

agement to address in real time the company's issues, problems and opportunities. In 2009, this real time collaborative decision making process permitted private equity portfolio companies to respond to the severe market dislocations.

» Private equity is an attractive alternative asset class for investors. As limited partners analyse the performance of their different alternative asset classes (e.g., private equity funds, hedge funds, real estate funds, etc.) during the 2007 - 2009 financial crisis and disruption, and compare these results to the performance of the top tier private equity firms, market participants anticipate that these limited partners, in the main, will reaffirm, and perhaps increase, their allocations to private equity. Some investors, however, such as certain US university endowments, will need to reduce their exposure to private equity as they rebalance their portfolios after the financial crisis.

While the top-tier private equity firms will benefit from these positive trends, and be able to exploit these opportunities in 2010, not all private equity firms will be in such a favourable position. Some private equity firms, burdened by both portfolio poor investment decisions made at the height of the 2008 - 2007 cycle and the lack of dry powder for new investments will be on the sidelines in 2010, unable to make new investments and unable to convince investors to support a new fund.

For the top-tier private equity firms, however, 2010 will be a rewarding year with the global changes and developments described in this article creating the potential for unparalleled global investment opportunities.

Private equity firms are now global in their scale, reach and investment focus

Kirk Radke is recognised internationally as one of today's top private equity and corporate attorneys. During his 25 year career, he has handled every type of complex business transaction for global private equity and corporate clients. Most recently, Mr Radke was named Best Private Equity Lawyer in the US for 2009 by *World Finance*. Included in *Chambers USA*, America's Leading Lawyers for Business since its inception in 2003, he ranks nationally as a Tier 1 attorney in *Chambers USA*, America's Leading Lawyers for Business in the Private Equity: Buyouts category. Additionally, Mr Radke is the only attorney to rank in Tier 1 for Private Equity: Buyouts and also rank in Investment Funds: Private Equity: Fund Formation. Clients describe him as "a terrific lawyer with an exhaustive practice" and a "terrific all-around deal lawyer" who "knows the intricacies of the industry at the highest possible level." He is also regularly recognised by *Best Lawyers*, *Super Lawyers*, *Practical Law Company*, *International Who's Who* and *IFLR's Guide to the World's Leading Lawyers*.