A watershed year for private equity

The industry could be an engine of growth in the 'great recovery.' Selwyn Parker speaks to Kirk Radke, a partner at Kirkland & Ellis LLP

"If you need to declare war on someone, he's your man." The 2010 Chambers directory of America's Leading Lawyers for Business lauds Kirk Radke's meticulous approach

[Kirkland's] private equity practice is routinely ranked number one in America. Indeed partner Jack Levin is known as the "father of private equity law"

Private equity in the US and elsewhere faces a turnaround as it recovers from what many predicted would be a near-death experience in the wake of the global financial crisis. The coming funding rounds in the US, Europe and elsewhere as houses pursue investment capital from the banks and other capital sources will make a profound statement about the medium-term future of private equity, predict industry players.

Among other things the capital raisings will shed a much-awaited light on:

» Those firms that emerged in the best shape from the recession;
» How the crisis has reshaped the industry, particularly in terms of the banking industry's new norms of leverage, governments' continuing revision of pre-2008 corporate tax rules, some target companies' distrust of buy-outs and tougher loan documents;
» Willingness of the big banks to fund buy-out firms as they face globally mandated higher levels of capital under the Basel III rules, much closer scrutiny by regulators, and uncertainty about future sources of revenue because of the "too big to fail" debate;
» The strength of the buy-side market, both primary and secondary, as companies are put on the auction block.

Taking everything together, it's been a long time since the industry faced as many questions as it will throughout 2011.

As Kirk Radke, senior partner in global law firm Kirkland & Ellis, a specialist in American and international private equity law, and veteran observer of the industry, points out: "The round of fund raisings will be fascinating to watch because we've had so little in the last few years. The $15bn raised by Blackstone was an anomaly. These capital raisings will establish the pecking order – the winners and losers, the houses that came through the fires and the ones that got burned. I believe we'll see the emergence of three stratifications of firms – the truly international ones, the middle-tier ones that focus on a country or region, and the smaller ones."

Deal activity is already clearly on the boil. Among numerous other deals in the pipeline, PAI Partners has put up for sale its €1-1.3bn half-share in Yoplait, the French fresh-milk giant (at least a dozen suitors are lining up including Nestlé), and Apax Partners has put $3.89bn in cash on the table to buy Smiths Medical.

Yet while big questions will be asked and answered during 2011, Mr Radke is in no doubt about the general health of the private equity industry. As far as he's concerned, its business model, which had become increasingly controversial before the crisis hit in late 2008, weathered the storm so well that it proved itself to the many doubters and is all the more robust and credible for it.

"The private-equity structure permitted companies to work their way through a cycle of recession. Firms worked closely with companies to save jobs. Franchises were not destroyed. And the industry has come out of it all in a very strong position," he summarises. "We saw true added value, not just financial engineering. Private equity's model of corporate governance has been strongly validated."

That also happens to be the view of buy-out professionals in the USA. According to a survey early in the new year, more than two thirds of respondents say the valuations of their portfolio companies have risen in the last year, which augurs well for prices in 2011.

Kirk Radke can fairly lay claim to having an inside view of the private equity industry. He's a columnist, lawyer and deal-facilitator who sits around the table during transactions and is often called in to deal with particularly challenging legal issues, both in America and abroad. Indeed last year's Chambers USA described him as "ahead of the pack when it comes to private equity" in its listing of America's leading lawyers for business.

His firm, 101 year-old Kirkland & Ellis, is the 11th largest law firm in the world measured by revenue. Its clients in commercial litigation include some of the jewels of the Fortune International 500, such as Samsung Electronics, Siemens AG, General Motors and BP (which it is defending in the wake of the Deepwater Horizon disaster). And past partners include some of the finest legal minds in recent US history, such as Supreme Court nominee Robert Bork, former solicitor-general Kenneth Starr and current partner and former White House policy adviser Jay Lefkowitz.

As for the firm's private equity practice, it's routinely ranked number one in America. Indeed partner Jack Levin is known as the "father of private equity law".

TWO HARD YEARS

The prospects for private equity certainly didn't look rosy in 2009. When the curtain came down on the long boom fuelled by low-cost debt – a period known as the "great moderation," credit dried up overnight and the doomsayers greatly outnumbered the optimists. Indeed, many of the pessimists were in the industry. According to a late-2009 survey by KPMG, no less than 58 percent of professionals did not expect demand for IPOs to recover by 2011 "at the earliest."

But that was then. The doomsayers were surprised – and so, perhaps, were some private-equity firms – at how quickly the industry adapted in almost Darwinian fashion to the downturn. As the credit in hedge funds ran out and clients exercised their right of redemption and withdrew funds in droves, the most nimble-footed firms dusted off their management skills.

"This is what I often emphasise about the very nature of the private equity market over the last four years," Mr Radke notes: "It's a market that changes quickly and dramatically. Indeed the rate of change is quite remarkable, and the industry has changed with it."

Instead of bemoaning the post-2008 credit-starved environment, much of the private-equity community concentrated on working on their portfolio companies and, as the industry says, "sweating the capital" already employed in those businesses. The primary mission was simple: the companies had to survive. After all, as Mr Radke observes, "a significant amount of their own and other people's capital was at risk."

Also at risk were their reputations. The firms knew that when the curtain did eventually rise and credit became plentiful once again, it would be those houses that managed their portfolio companies best that would be the preferred borrowers in the new environment as well as the preferred firms for new investor commitments.

And contrary to the predictions of many critics who regarded leverage as a dirty word, debt capital helped save many a company because the free cash got them through the crisis. "It was leverage that permitted many portfolio companies to survive in 2009," explains Mr Radke. "The loan capital acted as a stimulus."

Similarly, much-derided easy terms of credit in the form, for example, of covenant-lite documents written in the boom days also helped keep otherwise stricken companies alive. Because they gave much greater flexibility to private-equity borrowers in terms of penalties and repayment schedules, the less rigorous fine print threw a lifeline to hard-hit businesses.

> *"I don't see any material effect on the industry from Dodd-Frank"*

CASH IN HAND

As America recovers from its own recession, it looks very much as though private equity will serve as one of the main engines of economic growth. "The US will continue to be a very strong territory for the sale of portfolio companies," predicts Mr Radke, citing the number of cashed-up houses sitting eagerly on the sidelines, itching to jump back into the markets. "There's a number of strategic players with very significant investment funds on the balance sheet. Even if they make a modest entry into the market, they will push up prices."

As a result, he predicts a more competitive market than we've seen in the last two years: "It will probably be challenging to buy companies because the market will be stronger. But I do see a very strong buy-side in America."

FUTURE OF LEVERAGE

In early post-mortems on the crisis, private equity was singled out for blame because of the high levels of leverage commonly employed in buy-outs that ran into trouble. For instance, in the dark days the residual value of UK-based Candover group's 10 biggest investments including energy firm Expro International fell by 13 percent in the first six months amid doubts by investors about its ability to raise cash. And Apax Partners had to refinance £1.5bn in debt in Travelex, contributing to a doubling of losses.

However, regulators largely exonerated the industry from contributing significantly, if at all, to the general mayhem in the financial industry at large. As a result, private equity has largely escaped the regulatory net now being thrown over the mainstream banking industry. For instance the Dodd-Frank laws, blueprint for the overhaul of the banking industry, did not set out to rein in private equity in the same way that it did for Wall Street. "I don't see any material effect on the industry from Dodd-Frank," summarises Mr Radke.

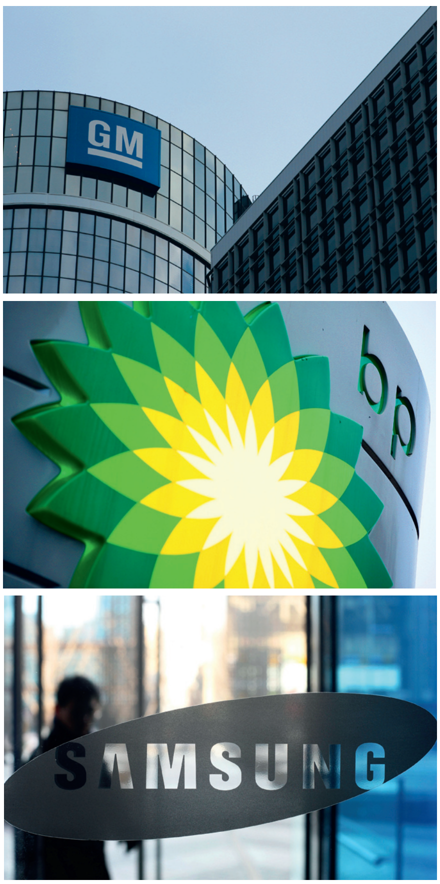
Similarly, he expects private equity will take in its stride the additional transparency required by the Securities and Exchange Commission – "the extra disclosures won't be a burden."

Another much-watched issue in the forthcoming fund-raisings will be what level of debt-to-equity ratios the funding sources will settle on. For the meantime, notes Mr Radke, "the finance market seems very strong and could strengthen during the year."

In turn that augurs well for higher ratios than those that prevailed in the last two years. "I believe levels will revert to pre-2008 numbers," suggests Mr Radke. "I don't see a new normal of leverage because of the crisis."

MONEY GOOD

The American private-equity model has survived the crisis more or less intact, but with some important changes. Take, for example, the



The 101 year old firm Kirkland & Ellis counts a number of high profile international companies among its commercial litigation clients

Big questions will be asked and answered during 2011

once-burning debate about those deals that fell through between announcement and execution. At the height of the boom, numerous transactions were not closed because lenders pulled the rug before closing, citing among other items a deterioration in a target company's performance and its reduced viability. Left in the lurch when this happened, some private-equity houses and target advisors campaigned for the introduction of the UK's 'certain funds' model that effectively guaranteed the deal would go through because the availability of the debt capital was not in doubt.

As Mr Radke recalls: "It was an open question in the US on how boards, PE firms and banks would address that funding risk. The 'certain funds' model could have been imported from Britain but it wasn't. Instead, the American industry has evolved to a model that shares the risk and facilitates the transaction."

Essentially, the American response is a streamlined version of the pre-crisis model and involves several distinct steps. First, the private equity house makes a formal acknowledgement that if the bank is willing to fund the purchase of the target company, and the other conditions of the transaction have been met, then the private equity firm will fund its equity commitments. This is 'money good' and equates approximately to 'certain funds' in this scenario.

As such, explains Mr Radke, "it makes a very powerful statement to the target board."

Second – and the main difference today – is that a firm has to suffer a quite serious setback under "material adverse" clauses before the bank can pull the rug.

Third, a shorter period between the signing and closing of the deal acts against the company running into the kind of trouble that may give a lender a reason to walk away.

Finally, if the bank withdraws without sufficient reason, the target company must be reimbursed through a compensation fee based on its break-up value at a ratio of 1.5-2 times. "And it's a very painful thing for anyone to have to write that cheque," adds Mr Radke.

While this updated model will be put to the test in coming months as the private equity market gets busier, Mr Radke believes it's robust enough to do the job. As he summarises: "The market has adopted a model that addresses risk, enables the completion of transactions, addresses the problems of 2008 and deals with differences in the UK model."

GLOBAL OUTLOOK

There's no doubt that private equity is on the move, hurtling across regions and borders, adapting almost effortlessly as it goes. Not all deals involve billions of dollars – indeed far from it – but the ultimate results are significant in their own way. For instance, in Brazil the Stratus Investment group recently bought into domestic recycling business Unnafibras and is working with management towards an IPO in three to five years time. By then, through acquisitions and investments, the Brazilian company will be significantly bigger than it is now.

Thus Stratus is deploying capital and expertise to grow Unnafibras in exactly the same way that, as Mr Radke outlined, the industry did in the last two challenging years. That is, by working hard on portfolio companies.

"It's very exciting to see the legal system in different jurisdictions adopt private equity," enthuses Mr Radke. "It's like what happened in Europe in the 90s. It's a very gratifying time for a lawyer specialising in private equity." (A far-flung firm, Kirkland & Ellis has offices in London, Germany and Asia-Pacific as well as in its home base in the US.)

But far from particularly US-style or other forms of private equity migrating more or less unchanged as it becomes more international, the industry is changing in subtle ways when it crosses borders. This process of adaptation clearly delights Mr Radke who revels in the legal and corporate diversity that he witnesses as he travels around the world.

"I don't see a US, Europe or any other blend of intellectual property in international private equity," he explains. "It's become a model of corporate governance which is translatable in various forms into doing good business around the world and that includes emerging markets."

Indeed, the next day he was on a plane to Asia to feel the pulse of private equity there. ◇