



Private Equity Alert

January 2010

Weil News

- The 2010 Edition of Best Lawyers in America recognized our following partners in the areas of Leveraged Buyouts, Private Equity Law or Private Funds Law: Christopher Aidun, David Blittner, David Duffell, Shukie Grossman, Jeffrey Hitt, David Kreisler, Steven Peck, Charles Robins, Jay Tabor, Jeffrey Tabak, Doug Warner, Glenn West, James Westra and Barry Wolf
- The 2010 Edition of Chambers UK recognized our London office as a leading firm for private equity buyouts in the UK and recognized the following lawyers in that office in the field of private equity buyouts: Marco Compagnoni, Michael Francies, Mark Soundy and Jonathan Wood
- Weil Gotshal advised Blackstone Group and Lion Capital in connection with the sale of Orangina Schweppes Group to Suntory Holdings
- Weil Gotshal advised American Securities in connection with its \$673 million going private acquisition of GenTek
- Weil Gotshal advised Harbinger Capital Partners in connection with its \$268 million going private acquisition of SkyTerra Communications
- Weil Gotshal advised Advent International in connection with its \$380 million going private acquisition of Charlotte Russe
- Weil Gotshal advised eTelecare and its controlling stockholders, Providence Equity and Ayala Corporation, in connection with the business combination of eTelecare with Stream Global Services

Shaken, Not Broken

By Doug Warner (doug.warner@weil.com) and Michael Weisser (michael.weisser@weil.com)

This past year the private equity industry was shaken but not broken. The year began badly with the full gloom of the credit crunch with new loans virtually unavailable for acquisition financing. During the year private equity sponsors navigated, among other obstacles, difficult fundraising markets, liquidity constrained limited partners and portfolio company loan amendments, restructurings and bankruptcies. The mood brightened somewhat in the second half of the year as the primary loan market began to reopen and the rebounding equity markets facilitated portfolio company IPOs.

Certain pundits predicted that the private equity model was “broken” and that the credit crunch would irrevocably change the relationship between sponsors and their LPs and that many sponsors would be driven from the business. However, despite the credit crunch and the resultant turbulence for the private equity industry, the private equity industry survived 2009 and appears poised to continue to thrive for the foreseeable future.

This article looks back on some trends we saw in the industry in 2009. It also contains some predictions as to what awaits the industry in 2010 and beyond.

Trends in 2009

Some of the trends that we saw in the private equity market in 2009 included:

- *A Difficult Fund Raising Environment* – The difficult fund raising environment of 2008 continued into 2009. New sponsors had difficulty raising any capital and even many brand name sponsors were required to reduce the target size of their funds or to postpone fund raising. According to Dow Jones LP Source, a total of \$95.8 billion was raised by US private equity funds in 2009, the lowest total since 2003 and 68% off the pace in 2008.
- *Managing LP Liquidity Issues* – Some traditional LPs had significant liquidity issues, particularly in the first half of 2009, due to declines in the value of their liquid investments and the reduction in their cash flow from illiquid investments. This led to predictions that there would be a wave of secondary sales of LP interests at distressed prices which didn’t materialize (a number of institutions such as Harvard and Stanford tested the waters of auctioning off parts of their private equity portfolios but reportedly did not receive acceptable bids). It also led to predictions that there would be LP defaults on funding obligations. While some LPs did default on their funding obligations, this problem was not as serious as originally predicted although in at least one case a sponsor sued an LP to enforce its funding obligation.

- *Concessions to LPs Increase* – A number of notable sponsors made concessions to LPs in reducing commitments and fees and altering other material terms of fund documents in 2009. The Institutional Limited Partners Association also got in on the act and issued their “Private Equity Principles” in 2009. These principles articulate their view as to best practices as to the terms of the GP-LP relationship and are increasingly being cited by LPs in negotiations with sponsors as the basis for requested changes to the proposed terms in the fund documents. In addition, Calpers conducted a well publicized review of its relationships with certain sponsors in 2009.
- *Year of Living Safely* – The focus of many sponsors in 2009 was to focus on improving operations at performing portfolio companies and salvaging value at distressed portfolio companies. Many sponsors seconded employees full time to portfolio companies with a view to both strengthening management and also to focus on add-on acquisitions. Conversely, many sponsors focused on changes in management and strategy at distressed portfolio companies.
- *Getting to Know Your Lenders* – Many sponsors spent a lot of time with lenders to their portfolio companies in 2009. Much of the time was spent on transactions to avoid bankruptcy, including simple covenant amendments and amendments where the lenders required sponsors to invest additional capital. Other transactions focused on extending debt maturities through debt exchange offers or “amend and extend” transactions. However, for many sponsors their time was unfortunately spent on negotiating out-of-court restruc-

turings or prepackaged or prearranged bankruptcies where they lost most or all of their equity in the portfolio company.

The private equity model is still a very attractive model to both LPs that want superior returns over time and to management teams that want to grow a business in partnership with active owners.

- *The B Word* – Bankruptcies and out-of-court restructurings of portfolio companies spiked this year, with over 100 sponsor-backed portfolio companies filing for bankruptcy in the US, due to the difficult economic environment, the poor operating performance of many portfolio companies, the resultant covenant or payment defaults on loan agreements and the difficult conditions in the credit markets which hindered the refinancing of maturing loans. This affected even some of the companies with “covenant-lite” loans who were thought to be relatively immune to default due to the lack of covenants.
- *Brother, Can You Spare a Deal?* – Deals were in short supply for sponsors in 2009, with deal volumes at their lowest level since 2002 and suffering a 44% decrease against the anemic deal volumes of 2008 (which were already 69% off against the halcyon days of 2007). The only bright spot in an otherwise bad year was that activity picked up in the third and fourth quarters as the primary loan market began to reopen.
- *Modest Resurgence in the Primary Loan Market* – The deep freeze of the primary loan market in the first half of the year began to thaw in the second half. The initial thaw in many

cases took the form of “best efforts” rather than committed financings and “clubbed” financings where the sponsor put together in advance a group of lenders to finance an acquisition since the lead lenders didn’t want to take syndication risk on the whole financing. However, committed financing reappeared in a number of fourth quarter deals and the market even supported at least two new financings with a PIK toggle feature. Surprisingly, the primary loan market also financed several leveraged dividend recaps, including ones for Booz Allen and Goodman Global.

- *Bridging Funding and Valuation Gaps* – Two of the recurring themes in 2009 were how sponsors could bridge funding gaps due to the general unavailability of acquisition financing and valuation gaps when the seller still had pre-credit crunch level pricing in mind. Some of the more common solutions involved use of seller financing, earn-outs and financing acquisitions with all equity checks. Another solution to bridge the funding gap seen in a number of transactions involved structuring the acquisition so as not to require lender consent or inducing the lenders to the target company to consent to the change in ownership and leave their loans in place.
- *Return of the IPO* – One of the bright spots for sponsors in the second half of 2009 was the return of the IPO market which gave sponsors the opportunity to both make lucrative exits in an otherwise tough exit environment as well as to deleverage.

Predictions for 2010

Some of our predictions for the private equity market in 2010 include:

- *Difficult Fund Raising Environment Continues* – We would expect that

the difficult fund raising market, particularly for new funds and funds with less than stellar track records, will continue and that some funds will be pulled or will not achieve their target amounts. We also expect to see some interest by traditional LPs in the secondary market both to get exposure to sponsors that they normally don't invest with as well as to potentially invest in a seasoned portfolio at an attractive discount to NAV. In light of the difficulties of the current fund raising market as well as the ingrained problem for sponsors of having to continually market new funds, we would expect that sponsors will continue to look for alternative sources of more permanent capital.

- *Solid Upsurge in Deal Activity* – We would expect that deal activity should solidly rebound in 2010 compared to 2009 so long as the economic climate continues to improve and the equity and primary loan markets remain relatively strong. This would continue the rebound that we saw in the fourth quarter of 2009. Sponsors are sitting on a lot of dry powder and some have limited time horizons under which they can invest their remaining committed capital. Similarly, there is a backlog of sellers looking for exits for many healthy companies that weathered the recession well and could be financed as well as sellers concerned about potential increases in the capital gains tax rates in 2011. Nonetheless, we don't expect any quick return to the frenetic activity levels of 2006 and 2007.
- *Lenders Chasing Yield* – We would expect the modest recovery in the primary loan market to continue as lenders chase yield in a world where both their funding costs are

nominal and their risk-free returns yield close to zero percent. However, we also expect that lenders will be choosy about which transactions they finance since they may be in both the “moving” and “storage” businesses with loans they originate until primary CLO issuance returns in a meaningful way to allow them to more easily syndicate the loans they originate. In a positive sign, NewStar was just recently able to raise \$275 million for the first new middle market CLO issued since the CLO market collapsed amid the credit crunch.

- *The Coming Wall of Debt* – The fourth quarter of 2009 saw a significant drop off in portfolio company bankruptcies and restructurings as both the economy and the refinancing market improved. However, that improvement may be short-lived given the significant debt maturities that come due in 2011 to 2014 and the decline in value of many of the companies that issued this debt during the boom years. Certain of these companies will not be able to refinance all of their debt and will likely end up in bankruptcy or in an out-of-court restructuring.
- *Laissez Faire Attitude of Regulators Changing* – Sponsors have not historically had to worry about meaningful federal regulation of their activities on the basis that their operations did not pose much systemic risk to the financial system and their investors were largely sophisticated institutions rather than retail investors. That is likely to change as Congress will probably require many sponsors to register as investment advisers as part of any financial services regulation legislation that is passed. This will require sponsors to comply with the disclosure and substantive require-

ments of the Investment Advisers Act and to invest more time, effort and money in back-office operations and compliance. This will also subject sponsors to potentially onerous surprise audits by the SEC.

- *Death and Taxes* – Similar to regulatory reform, there is a good chance that Congress will pass tax legislation in 2010 that will adversely affect the tax treatment of carried interest and management profits interests.
- *Hit the Road Jack* – IPOs will likely continue to be a favored exit method for sponsors in 2010 as long as the equity markets remain stable. IPOs provide sponsors with both the opportunity to monetize all or a portion of their investment as well as some ability to deleverage the still heavily burdened balance sheets of many of their portfolio companies. We also expect to see an increasing number of exits through sales to strategics as CEOs of public companies become more optimistic about the economy in general and their industries and companies' prospects.
- *Return of Secondary Buyouts* – Secondary buyouts largely disappeared in 2009 other than in situations where existing debt could be rolled over in the acquisition. Given the improving primary loan market and the need for many funds to generate distributions for LPs who have seen their distributions from private equity funds plummet, we would expect to see a solid rebound in the number of secondary buyouts in 2010.

Private Equity Not Broken

This past year was a shaky year for the private equity industry with sponsors being pressured on all sides. However, the doomsday predictions did not come

to pass. The rebound for the private equity market serves as a reminder that private equity is not a flash in the pan. The Private Equity Council recently reported that from 1980 to 2005 the top quartile private equity firms delivered returns over that period that far exceeded the S&P 500 and other public market indices. Similarly, Harvard Management recently reported that it had earned an average of 15.5% per year in private equity for the ten fiscal years ended June 30, 2009 (which obviously included the significant losses of 2008 and the first half of 2009) and that those returns exceeded their public market equity returns by approximately 11% per year.

As we have previously observed, the private equity model is still a very attractive model to both LPs that want superior returns over time and to management teams that want the opportunity to grow a business in partnership with active owners and to create personal wealth and liquidity opportunities. The private equity model, based on the principles of rigorous due diligence by sponsors, active oversight of portfolio companies by sponsors, the alignment of economic interests of sponsors with management and LPs and the payment of carry to sponsors only upon realization of profits is still one of the best business models out there.

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