WEIL GOTSHAL

Private Equity Alert

January 2009

Fear and Greed

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Let's cut to the chase. This past year was an *annus horribilis* for the private equity industry. The financial crisis that started with the credit crunch in the summer of 2007 and accelerated with the collapse or bailout of numerous financial institutions worldwide in the fourth quarter of 2008 left many victims in the private equity industry in its wake.

Pundits have recently predicted that this financial crisis would result in a secular change in the market for private equity with a significant percentage of private equity funds going out of business and the industry materially shrinking. On the other hand industry leaders have reminded investors that historically some of the best private equity deals have been struck when times were gloomiest. Stephen Schwarzman reportedly recently stated that he was a "raging bull" on private equity. Guy Hands reportedly pointed out that if Wall Street had worked on a "carry basis," as private equity sponsors do, Wall Street may have avoided many of the transactions that have contributed to the current financial crisis. We are similarly bullish about the private equity industry and the vitality of the private equity business model.

This article looks back on trends we saw in the industry in 2008. It also contains some predictions as to what awaits the industry in 2009 and beyond.

Trends in 2008

Some of the trends we saw in the private equity market in 2008 included:

- ***A Difficult Fund Raising Environment*** – The fund raising environment atrophied in 2008. New funds had difficulty raising any capital and seasoned funds had difficulty reaching their targeted amounts of capital. Traditional LPs found themselves unable or unwilling to make new commitments given that their allocations to alternative investments ballooned above their target allocations due to the so-called "denominator effect" of the decline in value of their stock and bond portfolios and due to the drought in distributions by private equity funds to LPs. Certain LPs also had issues with funding their current commitments and formally or informally communicated to sponsors a desire to defer capital calls to help them with cash flow issues or to reduce the overall size of their commitments to the funds. Sponsors responded in various ways to retain the goodwill of LPs as well as to discourage the selling by LPs of their LP interests on an already distressed secondary market. Permira, for example, reportedly offered a "pre-packaged default" option to LPs whereby they would release LPs from 40% of their commitments in exchange for the LPs giving up

Weil News

- The 2009 Edition of Best Lawyers in America named our following partners in the areas of Leveraged Buyouts, Private Equity Law or Private Funds Law: Christopher Aidun, David Duffell, Shukie Grossman, David Kreisler, Steven Peck, Charles Robins, Jay Tabor, Jeffrey Tabak, Doug Warner, Glenn West, James Westra and Barry Wolf
- Weil Gotshal advised Lehman Brothers Holdings Inc. in connection with the management buyout of Neuberger Berman and certain of its alternative asset businesses
- Weil Gotshal advised NBC Universal Inc. in connection with the consummation of the $3.5 billion acquisition of The Weather Channel by NBC Universal Inc., The Blackstone Group and Bain Capital
- Weil Gotshal advised Providence Equity Partners in connection with its $290 million going private acquisition of eTelecare Global Solutions, Inc.
- Weil Gotshal advised Getty Images Inc. in connection with its $2.4 billion public-to-private sale to Hellman & Friedman
- Weil Gotshal advised WL Ross & Co. in connection with its $1.1 billion acquisition of Option One Mortgage Corporation from H&R Block
- Weil Gotshal advised Advent International Corporation in connection with its acquisition of Hudson Group's retail business
- Weil Gotshal advised Avista Capital Partners in connection with the $4.1 billion acquisition of the ConvaTec business unit of Bristol-Myers Squibb Company

25% of the upside on their current funded capital and paying full management fees on their original commitment. TPG, on the other hand, reportedly offered to release all LPs from up to 10% of their capital commitments, reduce their management fee by a tenth and not to draw down more than 30% of an investor's total commitment in 2009 without advisory committee approval.

- ***The Great Fire Sale*** – This past year witnessed a great fire sale by LPs of interests in private equity funds, including brand name funds, at distressed prices. Advisory firm Cogent Partners recently reported that pricing for LP interests in the secondary market declined to an average of 61% of NAV in the second half of 2008 compared to 85% in the first half of 2008. The distressed pricing has both to do with uncertainty over valuations for investments made by 2005, 2006 and 2007 vintage funds at or near the top of the credit cycle, as well as a significant supply-demand imbalance between sellers and buyers.
- ***A Great Sucking Sound*** – That great sucking sound you heard in 2008 was of leverage leaving the system as Wall Street banks, CLOs, CDOs, hedge funds and mid-market lenders all largely shut down their lending operations to private equity sponsors and others. Lenders were unwilling to originate new loans due to concerns regarding their own solvency and the dampening effect of performing senior leveraged loans trading in the 60s and 70s in the secondary market. This was notwithstanding the good news that the pre-credit crunch leveraged loan overhang declined from a peak of $237 billion in July 2007 to approximately $15 billion by year end. Many of the buyouts that sponsors were able to complete in 2008 were all equity deals or deals where equity represented a majority of the capital structure.
- ***Significant Decrease in LBO Volume*** – The private equity industry suffered a 69% collapse in the value of sponsor-backed buyouts worldwide from 2007 and accounted for just 8% of worldwide M&A transactions in 2008 compared to 18% in 2007. The decline affected all sectors of the market, including mid-market buyouts, and was a function of the lack of available debt, the erosion of EBITDA at many target companies and the difference in price expectations between sellers and buyers.

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- ***Continued Unraveling of Boom Era LBOs*** – A number of sponsors found themselves in litigation with sellers and lenders in 2008 over the continued unraveling of some of the mega LBOs announced in 2007. From cases like URI and Huntsman, buy-side sponsors learned a number of lessons, including making sure that your reverse termination fee is the seller's sole and exclusive remedy against you and that it is dangerous to rely on a material adverse effect clause to walk away from a transaction. The overriding lesson for sponsors is that careful drafting and good lawyering do matter when a deal doesn't work out as planned.
- ***Tending Your Garden*** – By the second half of 2008, the primary activity of many sponsors was focusing on both their troubled and healthy portfolio companies. The name of the game for troubled portfolio companies was keeping them alive through equity cures, credit agreement amendments, revolver drawdowns, PIK toggle exercises and debt exchange offers. For healthy portfolio companies, sponsors focused on add-on acquisitions and opportunistic buybacks of discounted debt. Many portfolio companies filed for bankrupty protection in 2008 and many remain on Standard & Poor's "weakest links" list as most at risk of default.
- ***The Law of Gravity*** – Private equity sponsors discovered in 2008 that they were not immune to the economic reality affecting the economy generally and some were faced with difficult decisions as to whether to lay off employees or scale back offices and global ambitions. A number of private equity sponsors did lay off employees and close offices in 2008 and headcount in the industry is likely to continue shrinking in 2009.

Predictions for 2009

Some of our predictions for the private equity market in 2009 include:

- ***Sponsors Continue to Manage LP Liquidity Issues*** – We would expect that certain other sponsors will follow the lead of Permira and TPG in 2009 in accommodating LP liquidity issues to both retain the goodwill of LPs as well as to relieve some of the pressure on LPs to sell LP interests in the secondary market. We would also not be surprised if certain sponsors face the prospect of LP defaults on capital calls in 2009. We would also expect in 2009 to see the continued strong interest by LPs in secondary sales of their LP interests both to address liquidity and rebalancing issues.

- ***Reduced Private Equity Activity Continues*** – We don't expect any quick or vigorous rebound in private equity activity, particularly buyouts, in 2009. There are no signs that any significant lending activity to sponsors to fund buyouts will resume in 2009. Wall Street banks are still paralyzed with fear and are mostly focused on managing their existing assets and their solvency rather than on originating new leveraged loans. Sponsors also are fearful about the fate of many of their existing portfolio companies and a lot of their near term focus will be consumed by salvaging value from their existing portfolio rather than making new investments. We also don't anticipate any significant increase in private equity activity by hedge funds and sovereign wealth funds. Many hedge funds are more focused on managing their own liquidity due to actual or potential redemption requests rather than on making new illiquid investments. Sovereign wealth funds have capital to invest but have not to date made a significant number of direct investments in buyouts.

- ***Sponsors Focus on Different Types of Transactions*** – With the debt markets largely closed, new investments by sponsors will be targeted at transactions that require little or no incremental leverage. For example, we would expect that the investment mix will shift to transactions such as PIPEs, growth capital investments, portfolio company add-on acquisitions that can be funded with existing credit facilities or additional equity, investments in inherently leveraged companies, such as banks, acquisitions that are structured to preserve existing leverage and additional equity investments in existing portfolio companies. We also would expect that sponsors may more frequently partner with strategic investors to enhance their access to whatever leverage is available and to engage in hostile transactions. We will probably also see an increase in seller financing in 2009 to address funding issues as well as earn-outs to address valuation issues.

- ***Return to Their Knitting*** – LPs have complained about style drift at some private equity sponsors. We would expect sponsors to return to their core competencies and shut down activities and offices not key to their operations. We would also expect a continued reduction in headcount in the industry in 2009.

- ***A World of Distress*** – There will be opportunistic buying opportunities in the current environment to savvy investors with distressed expertise. This can range from negotiated acquisitions inside or outside of bankruptcy to "loan-to-own" strategies.

- ***Regulatory Shoes to Drop*** – It seems likely that regulatory changes affecting private equity sponsors will come out of the current financial crisis. A number of regulatory initiatives have already been announced in Europe. In the US, it would not be surprising to see renewed attempts to regulate private investment managers and changes in the tax treatment of carried interest.

Looking Beyond the Abyss

Although there is still abundant fear in the market we agree with the private equity industry leaders who believe that the market for the next 12 to 24 months will prove, in hindsight, to have been a great market to deploy capital before the pendulum swings again and there is too much capital chasing too few attractive investment opportunities. Despite the absence of easy credit and still some divergence in valuation between sellers and buyers, deals can still get done but private equity sponsors will need to be creative in originating and structuring those deals. Sponsors who are still greedy to make new investments in 2009 and 2010 are likely to be rewarded.

A recent study by Coller Capital indicated that LPs still believe in the private equity model as 97% of surveyed LPs expected to maintain or increase their allocations to private equity. Similarly, the private equity model is still an attractive model to management teams that want the opportunity to both grow a business in partnership with active owners and create their own personal wealth. The private equity model, based on the principles of active oversight of portfolio companies by sponsors, the alignment of 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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