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Private Equity Alert

Partying Like It's 2004

By Doug Warner and Michael Weisser

Private equity dealmakers breathed a palpable sigh of relief in 2010. After two years characterized by anemic deal activity, limited and expensive debt financing, all "equity checks" and a lot of time spent salvaging and restructuring portfolio companies and their debts, the deal market returned strongly in 2010.

Although the deal market didn't return to the halcyon days of 2006 and 2007 (or even 2005 for that matter) there was a solid level of LBOs announced throughout 2010 and, in particular, in the second half of the year. Fuelling the deal market was a record setting level of high yield bond issuance and a solid primary loan market. Also driving the deal market were both LP demands for distributions which factored into decisions made by private equity sponsors to sell assets as well as the desire for private equity sponsors to invest their remaining capital before their commitment periods expire in order to diversify their holdings. Activity in Washington also sparked this activity as the uncertainty regarding potential tax law changes incented private equity sponsors and other business owners to sell.

This article looks back on some of the trends we saw in the private equity industry in 2010. It also contains some predictions as to what awaits the industry in 2011 and beyond.

Trends in 2010

Some of the trends that we saw in the private equity industry in 2010 included:

- *Happy Days Are Here Again* – This past year saw a significant rebound in deal activity by private equity sponsors. Dow Jones reported that buyout deals were up 84% in 2010 to $194.6 billion compared to $105.5 billion in 2009. In particular, there was a surge of going private activity with 40 announced going privates in 2010 with an enterprise value of $100 million or more compared to only 14 in 2009. The announced deals were also markedly larger with two $5 billion plus LBOs announced in 2010 and rumors in 2010 of at least one $10 billion plus LBO which did not come to fruition. Secondary LBOs were a popular theme throughout the year as private equity sponsors were both active sellers and buyers in 2010. There was even a modest resurgence in club deals among some of the larger LBOs.
- *Which Lane Do I Take?* – Another theme in 2010 were dual track sale processes. A number of sale processes included dual track IPOs and sales to maximize value for the sponsor and some even included dual track sales and dividend recaps in the event that the sale process did not achieve an acceptable valuation.

Weil News

- Weil advised Thomas H Lee Partners in connection with its acquisition of Acosta Sales & Marketing, a full-service sales and marketing agency in the consumer packaged goods industry
- Weil advised Unitas Capital in connection with its €525 million acquisition of Hyva holdings, the Dutch-based maker of hydraulic cylinders and tippers
- Weil advised various stockholders of Universal American, including Capital Z Partners, Lee Equity Partners and Welsh Carson, in connection with the $1.25 billion sale of Universal American's Medicare prescription drug business
- Weil advised HgCapital in connection with its sale of Pulse Staffing, the UK's leading independent health and social care staffing services business
- Weil advised Snow Phipps Group in connection with its acquisition of APC Workforce Solutions, a provider of employment outsourcing solutions
- Weil advised Lone Star in connection with its acquisition of German mortgage bank Dusseldorfer Hypothekenbank Aktiengesellschaft
- Weil advised The Gores Group in connection with its sale of Vincotech Holdings, a Germany-based manufacturer of electronic components

- *Not Everything Came Up Roses* – On the other hand, one of the side effects of the rebound in deal and debt markets were the large dollar signs in the eyes of certain sellers. A number of sales processes stalled in 2010 due to valuation gaps between sellers and buyers. Some of these resulted in dividend recaps and other deals were just pulled.
- *Stockholders Getting Testy* – Stockholders of public companies also proved resistant to the allure of some deals in 2010 and turned down some going private transactions, including the proposed acquisitions of Cedar Fair and Dynegy.
- *Wall of Available Debt* – Due to the strong primary financing markets, liberal debt terms returned in 2010 with some new "covenant-lite" loans and PIK toggle bonds. The strong primary financing markets were driven by a worldwide search for yield in an era of close to zero risk-free interest rates and the improving global economy. CLO refinancing activity returned and there was a modest amount of formation activity for new CLOs. A number of private equity sponsors also took advantage of the strong primary financing markets ahead to refinance or "amend and extend" debt maturing in the next few years.
- *They Used to Call it Junk* – This past year also saw a record issuance of high yield bonds. However, the issuances tended to be by seasoned issuers in connection with refinancing or other activities rather than by new issuers to the market to finance acquisitions.
- *Brother, Can You Spare a Dividend?* – Dividend recaps returned in a big way in 2010. Private equity sponsors and their LPs were looking to extract value from their existing portfolio companies either through a sale or a recapitalization. This activity was particularly energetic in the fourth quarter of 2010 due to concerns that federal income tax rates on dividends would increase in 2011.
- *Opening Your Raincoat* – A large number of PE-backed companies filed for IPOs in 2010 both to deleverage and to realize on their investments. However, more companies had aspirations of going public than actually did. This was partly due to the volatility in the stock markets in 2010 and the concerns of public investors over the high amount of leverage at certain of these companies. We expect IPOs to be a significant theme going forward for private equity sponsors, particularly with respect to the mega LBOs of 2005 to 2007 as there may not be a natural exit for an investment in those companies other than through a sale to the public. Among others, Nielsen, HCA and Kinder Morgan have filed for IPOs that are in the pipeline.
- *The Not So Bad Political News* – The private equity industry faced a number of regulatory and tax challenges from

Washington at the beginning of 2010. By the end of 2010 the industry had emerged from those challenges with relatively little change on the tax front, though many private equity sponsors will now be required to register as investment advisers. No tax law changes impacting the carried interest tax were enacted and some of the regulatory changes, such as the Volcker Rule, may end up being a net positive for much of the industry.

- *Now For the Bad News* – The private equity fundraising market is still weak. Dow Jones reported that US private equity funds raised a total of $86.3 billion in 2010 compared to $102.2 billion in 2009. LPs are reluctant to commit given their current exposure to the industry compared to their target allocations and the relative paucity of distributions until recently. LPs are also increasingly reluctant to commit to new and emerging private equity sponsors, are trying to pare down the number of private equity sponsors with whom they invest and the more sophisticated LPs are increasingly looking at making direct investments. The balance of negotiating power has also modestly shifted to LPs through efforts by the ILPA and simple market dynamics.

Predictions for 2011

Some of our predictions for the private equity industry in 2011 include:

- *Let the Good Times Roll?* – We expect a continuing strong rebound in deal activity in 2011 given the current economic rebound and strong debt markets as well as the need for private equity sponsors to deploy capital and to realize investments for their LPs. Based on the activity in the first few weeks of 2011, strategic M&A may begin a strong rebound which could give private equity sponsors an additional liquidity alternative.
- *Going Abroad?* – We expect US sponsors to continue to diversify by looking at international opportunities due to the perception of potentially stronger growth outside the US. Although international investment opportunities may prove attractive, they also come with some unanticipated risks, including currency risks and potentially uncertain tax, regulatory and legal regimes.
- *Lenders Everywhere You Look* – We expect the leveraged finance markets to continue to be strong in 2011 given the yield alternatives available to investors and the modest rebound in CLO formation activity.
- *The Great Refinancing Wall* – We expect continued private equity sponsor focus on refinancing debt maturing in 2012 to 2015 ahead of schedule while debt markets remain strong through traditional bank and high yield refinancings as well as amend and extends and exchange offers.
- *Reluctant LPs* – We would expect a modest resurgence in fundraising equity for private equity sponsors. Many LPs remain committed to the asset class above their target allocation. The holy grail for private equity sponsors will continue to be finding a more permanent source of capital than the current model.
- *Selling the Elephant* – Private equity sponsors will increasingly look to monetize their investments in the mega LBOs of 2005 to 2007 given the hold times of those investments and the private equity sponsors' (and LPs') desire for distributions. There may be no natural strategic buyer for a number of these investments so monetizing these investments at a reasonable valuation could prove challenging. If early indications hold, the investments in many of these mega LBOs will likely be monetized through the IPO market.

Private Equity Is Back

In our last annual review of trends in the private equity industry in January 2010, we observed that 2009 was a shaky year for the private equity industry but that the private equity model was not broken. This past year proved that. However, the private equity industry does face a number of challenges going forward. One of the primary challenges is the need to dedicate a substantial amount of time every few years to raising a new fund as the previous fund becomes committed and relying upon LP appetite at the time to raise capital. Private equity sponsors will continue to search for a more permanent form of capital.

Another of the challenges is that the landscape of private equity sponsors has become more and more crowded and LPs may pare down the number of private equity sponsor relationships they have. This was highlighted in Harvard Management Company's recent annual report where they indicated that they remained committed to the asset class but that they anticipated reducing the number of active relationships with private equity and venture capital sponsors and increasing their level of concentration with the relationships they do retain. However, we expect the private equity model to continue to flourish and to provide opportunities for entrepreneurial deal professionals.

Happy New Year to all of our clients and friends.

Private Equity Alert is published by the Private Equity Group of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1 212 310 8000, http://www.weil.com.

The Private Equity Group's practice includes the formation of private equity funds and the execution of domestic and cross-border acquisition and investment transactions. Our fund formation practice includes the representation of private equity fund sponsors in organizing a wide variety of private equity funds, including buyout, venture capital, distressed debt and real estate opportunity funds, and the representation of large institutional investors making investments in those funds. Our transaction execution practice includes the representation of private equity fund sponsors and their portfolio companies in a broad range of transactions, including leveraged buyouts, merger and acquisition transactions, strategic investments, recapitalizations, minority equity investments, distressed investments, venture capital investments and restructurings.

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