

Private Equity Alert

Business As Unusual

By Doug Warner and
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2011 was an interesting time for the private equity industry. It was a year that started off with a bang but ended with a whimper. Overall for 2011, private equity deal volume was largely flat compared to 2010, but it was heavily front-loaded with fourth quarter LBO volume in 2011 declining 38% against the comparable quarter in 2010 according to Thomson Reuters.

The overarching theme of 2011 was uncertainty – macroeconomic, political and regulatory. There was a steady drumbeat of bad news with the US ratings downgrade, European sovereign credit risk, the political dysfunction in Washington, the political dysfunction in Europe, the looming presidential election in the US, the uncertainty over future bank capital rules and the implementation of Dodd-Frank among other items. The impact of this on the industry was a weaker debt financing market in the second half of the year, a disappointing IPO market and a dearth of strategic buyers of businesses. Despite this, the industry had a solid year and had real success in a number of areas, including pushing out the refinancing wall of debt maturities that arose from 2006 and 2007 vintage LBOs.

This article looks back on some of the trends that we saw in the industry in 2011. It also contains some predictions as to what awaits the industry in 2012 and beyond.

Trends in 2011

Some of the trends that we saw in the private equity industry in 2011 included:

Alive and Well – The good news is that the LP community remains committed to the asset class. According to Buyouts, over \$90 billion of buyout funds were raised in 2011 compared to just over \$69 billion in 2010. A recent survey of LPs by Collier Capital concluded that 83% of surveyed LPs plan to maintain or increase their target allocation to PE over the next year. Interestingly, Collier Capital's survey concluded that LPs viewed mid-market and small buyout funds to provide better opportunities than large buyout funds with approximately one third of LPs planning to scale back their investment in large North American buyout funds.

Calling Mr. Darwin – Even though the LP community remains committed to the asset class they are becoming more discriminating and the structures and terms of new funds are evolving. Whereas many of the more successful mid-market buyout funds relatively easily raised capital exceeding their previous funds in 2011, other funds had significant difficulties in raising capital at anywhere near the size of their previous funds. LPs also continued their push to improve deal terms and many notable sponsors reportedly made concessions on management fees,

Weil News

- Weil advised Oak Hill Capital in connection with the \$4.2 billion sale of its portfolio company, RSC Holdings, to United Rentals, Inc. in a cash-and-stock transaction
- Weil advised Canada's Public Sector Pension Investment Board in connection with its participation in a consortium of investors effecting the \$6.3 billion take private of Kinetic Concepts, a US-based medical devices company
- Weil advised Thomas H Lee Partners in connection with its \$2.2 billion acquisition of Acosta, Inc., a leading full-services sales and marketing agency in the consumer packaged goods industry
- Weil advised Berkshire Partners and OMERS Private Equity in connection with their \$2.1 billion of Husky International, a Canada-based manufacturer of injection molding machines, molds and integrated systems
- Weil advised Mubadala Development Company in connection with its participation in the \$2.2 billion acquisition of EMI Music Publishing by a consortium which also included Sony Corporation and Blackstone Group
- Weil advised Providence Equity in connection with its \$1.8 billion take private of Blackboard, a developer and licensor of e-learning, transaction processing, e-commerce and online community software applications and related services

carried interest percentages, transaction fee offsets, hurdle rates and other terms. One other new structure we saw in 2011 which could become a trend was large LPs making large commitments to a sponsor across multiple platforms and funds in exchange for concessions on fees and other terms. A notable example of this was the \$3 billion commitment that Texas Teachers' Retirement System reportedly made to both KKR and Apollo.

Keeping Your Dry Powder – One of the trends that we began to see in 2011 and expect to see more of in 2012 is for sponsors with 2006 and 2007 vintage funds with undeployed capital to approach their LPs regarding extending the commitment period. This will permit sponsors to avoid deploying capital prematurely in order to not lose the opportunity to use the capital and to potentially defer their need to raise additional funds. LPs may be amenable to extending the commitment period so as to disincite sponsors from deploying capital imprudently prior to the expiration of the original commitment period.

Risk Off – As noted above, deal activity started strong in 2011 but then tailed off given the increasing macroeconomic and political uncertainty that heated up over the summer months which dramatically dried up the debt financing markets. The debt financing markets recovered modestly in December but that was largely due to a supply-demand imbalance given the relatively small number of leveraged deals that were in the pipeline to be funded. The reduced level of activity in the second half of the

year, and particularly in the fourth quarter, suggests that there will be a slow start to deals in 2012 as people get back their sea legs.

How Do We Get Out of Here? – It was also a tough environment for deal exits in 2011. As noted above, the financing markets became difficult in the second half of the year, strategic buyers were few and far between and the volatility in the equity markets did little to shorten the long queue of sponsor-backed companies lined up to go public. On the bright side, 2011 was a decent but not spectacular year for dividend recaps, particularly in the first half of the year.

Kicking the Refi Wall Down the Road – One of the success stories of 2011 was the ability of sponsors to extend the maturities of the debt issued to finance their 2006 and 2007 vintage LBOs. The debt financing markets were strong in the first half of the year which allowed many sponsor with 2012 to 2014 debt maturities to extend those maturities through amend and extends and exchange offers. This will take the pressure off sponsors to exit or permanently refinance many of their portfolio companies prematurely.

Predictions for 2012

Some of our predictions for the industry in 2012 include:

Continuing Shakeout in the Industry – We believe that the fundraising environment for many funds will continue to be difficult and it is not clear that certain sponsors will be able to raise funds of a sufficient size to support their current operations or to stay in business. We would

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- Weil advised Ontario Teachers' Pension Plan in connection with its participation in the \$1.3 billion going private acquisition of Blue Coat Systems by a consortium led by Thoma Bravo
- Weil advised Advent International in connection with its €1.15 billion acquisition of the Card Systems and Identity divisions France based Oberthur Technologies

expect that certain funds will engage in selective "downsizing" and that others may slowly go out of business entirely. This will also make it more difficult for emerging fund managers to gain traction with LPs.

Continuing Diversification by Industry Players – In recent years, there has been significant diversification by some of the larger buyout funds. There are now several sponsors who have become or are becoming "alternative asset supermarkets" and offering a whole range of products, including large buyout funds, small buyout funds, regional buyout funds, distressed funds, credit opportunity funds, real estate funds, CLO funds, hedge funds, etc. under one roof. We would expect this trend to continue.

Difficult Deal Environment To Continue in the Near Term – The past year ended with many frustrated sponsors on the buy side (frustrated at the valuations being sought by sellers, the lack of good product for sale and the less than optimal financing market) as well as frustrated sponsors on the sell side (frustrated at the valuations being offered by buyers, the dearth of strategic buyers, the lack of a great IPO market and the less than optimal financing market). We would expect that frustration to continue in the near term due to the continuing political and economic uncertainty and sub-optimal growth prospects in the US and Europe and the continuation of the global "risk off" trade worldwide (10-year treasuries yielding less than 2% still have lots of eager buyers). Over the medium term we are optimistic about the level of deal activity as corporate buyers are cash rich, the debt markets appear

stable if not booming and stock markets hopefully have nowhere to go but up.

Debt Maturities Will Not Come Home to Roost Yet – As noted above, sponsors have been successful in pushing out a substantial amount of debt maturities from 2011 to 2014 to 2015 to 2017. This will give sponsors some breathing room but if the economy and the deal markets do not pick up by the beginning of 2013 or so sponsors may have debt maturity issues with a number of their portfolio companies.

Private Equity Will Live to Fight Another Day

In our last annual review of trends in the private equity industry in January 2011, we observed that although the private equity industry faced a number of challenges going forward, we expected that the private equity model would continue to flourish and to provide opportunities for entrepreneurs and deal professionals. As Collier Capital's recent survey noted, 83% of LPs intend to maintain or increase their exposure to private equity so the LP community is placing their bet on the future of the industry. In addition, a recent report by the Private Equity Growth Council reported that private equity had returned about 800 basis points of annual performance in excess of the S&P 500 over the last 10 years. In a world of 10-year treasuries yielding 2% and modest prospects for public equities, investors need private equity to exist and flourish.

Happy New Year to all 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>.

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