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## Private equity: turning the page from a challenging 2011

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WE WILL BE neither the first nor, we suspect, the last industry participant to observe the challenges that financial sponsors, and private equity investors in particular, experienced in 2011. As we progress into 2012, we do, however, find glimmers of hope.

*Limited partners.* The challenging fundraising environment continued in 2011. Institutional investors, particularly public pension funds, are paring back the number of relationships, which bodes well for large established sponsors who are viewed as more stable and with deeper pockets to help buffer market volatility. In some cases, fund target sizes have been adjusted downwards, with economic and transparency concessions having become the new norm thanks in large part to the ILPA guidelines. While concessions have varied among sponsors, what has become clear is that institutional investors remain committed to private equity, and those capable of writing large cheques are getting customised one-off arrangements with better economic terms. Whether through managed accounts, side-cars, direct investments, multi-strategy mandates or co-investments, institutional investors have taken advantage of the current fundraising cycle to actively partner with established sponsors in more creative ways, with the expectation of better returns in the long term. 2012 may turn out to be a mixed bag, but ultimately adequate, much like 2011. Continuing concerns about Europe may have a negative effect on fundraising, but capital coming available for deployment will need to find an investment and may contribute further to the differentiation we are already seeing between large established sponsors and everyone else.

*Banks and other financing sources.* The traditional bank commitment market continues to be flighty and fickle. Volatility is high – the windows open and close, quickly and across various geographic areas, and hitting the market at precisely the right time is critical. Deals are thus limited, but for those who are able to time it right, deals are getting done. We have also seen the continued participation of other financial players, such as sponsor-controlled mezzanine funds and credit funds, and other alternative lenders such as hedge funds, who have entered the void. Some sponsors have been willing to commit greater equity to get the deal closed, as a bridge to a future refinancing.

*Equity capital markets.* The same challenges that affected the financing of deals affected exits. The IPO market, whose receptivity to private-equity backed offerings was already diminished, shut as quickly as it opened, and so on. Portfolio companies ready to move quickly, however, did succeed in their offerings; the dollar value of 2011 sponsor-backed IPOs nearly doubled from 2010, while the number of offerings diminished significantly. We believe that it was the overall economy, and its impact on portfolio company performance, as much as the capital markets that may have resulted in a large number of abandoned offerings. As with debt financing, timing was critical to success – launching in a geography and week where the environment is accommodating was key, and therefore longer lead times and multi-jurisdictional tracks were often required. We may see some early exits in 2012, where exit is feasible, because the window may be shut at the more traditionally expected time.

*The courts.* While Delaware courts have, more than once, demonstrated a certain distrust of financial sponsors, 2011 saw some true flashes of deep judicial cynicism for some conduct in the M&A marketplace. However, the basic lesson of Delaware M&A law remains the same: a well-thought out deal strategy, which takes into account the requirements of Delaware directors' fiduciary obligations, and a well-functioning board, can succeed and those deals will survive challenge. The courts' bedrock respect for directors' business judgment, when evidenced by proper attention to material issues, remains intact.

*Sellers.* Many sellers cling to pre-financial crisis expectations for valuation, making whole-company transactions difficult to achieve. Extraordinary volatility makes it harder, not easier, to agree on terms. But the market is active with sales of divisions and subsidiaries, where valuation metrics are more malleable, and sellers can accept more creative deal terms, such as earn-outs, vendor financing and retained equity ownership. Those deals often bring much-appreciated liquidity to the corporate seller, as well as a concluding punctuation mark for the ownership of a troubled, under-performing, and/or non-core business – all of which are an excellent fit for private equity buyers.

*The regulators.* The ever-expanding labyrinth of US, UK, and EU regulation makes doing business for financial sponsors certainly more costly and perhaps more difficult; whether the original policy objectives are served is a matter of debate. On the other hand, global competition policy, which increasingly disfavours highly synergistic mergers among industry leaders, may actually improve the M&A prospects for private equity buyers.

2012 may be a year for bespoke, if somewhat sporadic, dealmaking in an environment that is well-suited to the private equity investment thesis. Creativity and advance preparation, as usual, will continue to be rewarded. ■