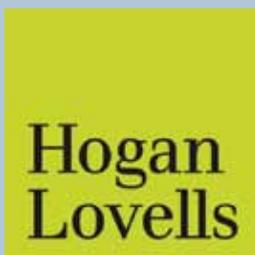


Wharton Private Equity Review

THE STORM CLOUDS BEGIN TO CLEAR



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THE STORM CLOUDS BEGIN TO CLEAR



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Private equity investors saw record yearly earnings in the boom years of 2005 to 2008 as easy access to financing led to ever-larger leveraged deals. Then it all came to a halt with the global financial meltdown. In 2009, PE firms with reasonable liquidity weathered a tough year as many put their portfolio companies through rigorous restructurings. This year, talk is slowly turning from retrenchment to opportunity, at least in the U.S. and Asia, according to speakers at a recent Wharton Private Equity and Venture Capital Conference titled "A New Dawn: Investing in the Post-Crisis World." However, private equity managers remain concerned about the broader economic environment, particularly in Europe, where the PE market faced further contraction even before the most recent sovereign debt crisis hit.

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With easy access to financing, large leveraged buyout firms grew to massive sizes during the private equity (PE) boom between 2005 and 2008, often with shares in deals valued in the billions. Now, following the global economic meltdown, speakers at the recent Wharton Private Equity and Venture Capital Conference, "A New Dawn: Investing in the Post-Crisis World," explored how the industry is faring. One speaker noted that, pre-crisis, there was a moment in time when "our industry forgot that we have to pay every penny of that debt." Another said PE firms are focusing on providing added resources to support their portfolio companies in today's suppressed markets. One upside of the boom years: Much of the PE financing in place has few or no covenants, which gives companies some breathing room.

Private Equity: Part of the Crisis or Part of the Solution?

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Panelists at the recent Wharton Private Equity and Venture Capital Conference considered whether private equity (PE) was a key contributor to the financial crisis — or a scapegoat — and also looked at what role it might play in a recovery. To the extent that PE has taken a hit to its reputation, the problem is one of communication, according to one panelist, because "it is difficult for the average newspaper reader to understand the role of PE in the economy." But another panelist argued that PE must "look in the mirror and admit we did over-lever and as a result overpaid. The benefit fell to the seller, not the buyer."

Expect Europe's Private Equity Market to Contract

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Dalip Pathak, head of Europe and India for Warburg Pincus, discussed the future of private equity and venture capital in his keynote speech at the recent Wharton Private Equity and Venture Capital Conference titled, "A New Dawn: Investing in the Post-Crisis World." Although deal flow is starting to pick up, Pathak nevertheless expects the private equity industry to contract in Europe with fewer firms managing somewhat smaller funds. He described the fundraising environment in Europe as "tough," observing that "we are not in a situation of stable equilibrium." As a result of the rise of China, India and emerging markets, "we are in a very dynamic situation and it is going to stay that way," he said.

Private Equity Opportunities in Emerging Markets Could Help Offset a Slow Recovery Elsewhere

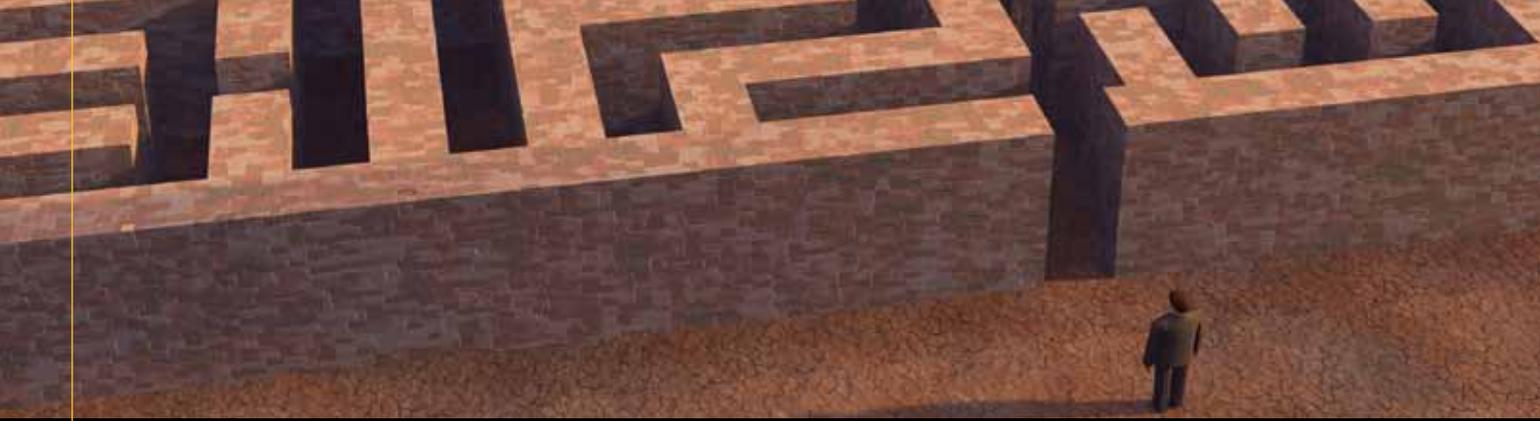
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While the United States and Europe were hit hard in the global economic crisis, many emerging markets have fared better and private equity investors may be poised to benefit from new opportunities overseas. But these markets are in different stages of maturity and each has unique opportunities and potential pitfalls, according to panelists at the recent Wharton Private Equity and Venture Capital Conference.

Is China Private Equity's Next Rock Star?

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Watch for China to become the world's center of private equity within five to 10 years, according to David Rubenstein, co-founder of The Carlyle Group. Paving the way for this top ranking are strong economic growth, myriad opportunities, little competition and a mostly laissez faire attitude towards business. "When I'm in Washington, D.C., people are barraging me, [saying that] I'm not paying enough taxes.... In China, people want my autograph. Private-equity professionals are like rock stars."



For PE Firms, Liquidity Remains the Key Issue

With easy access to financing, large leveraged buyout firms grew to massive sizes during the private equity boom between 2005 and 2008, often with shares in deals valued in the billions. Now, following the global economic meltdown, speakers explored how the industry is faring during a panel discussion titled, “Leveraged Buyouts: Generating Returns in a Challenging Climate” during the Wharton Private Equity and Venture Capital Conference.

The moderator, Wharton finance professor N. Bulent Gultekin, asked the panelists what they have learned since the collapse and how they are managing portfolio companies through the current cycle.

“We focus on core consolidation where necessary and on having much stronger companies coming through the other side of this crisis.”

Jacqueline Reses, Media Business Head,
Apax Partners

Jacqueline Reses, head of Apax Partners’ U.S. media business, said private equity is focused on helping CEOs and providing additional resources to support portfolio firms. Like many large, leveraged buyout firms, she said, Apax has a team of former executives and specialists with skills in areas such as cost control, sales and consumer use of the Internet, who can help portfolio companies with specific problems.

At the same time, the firm is also focused on managing costs throughout its operations. Apax was ahead of some other firms at the beginning of the financial crisis in 2007 and made sure its portfolio firms were positioned to support themselves through the downturn, Reses said. “I’m not sure anyone predicted it would be as bad as it was at the depths of 2008 and 2009,” noted Reses, “but we did our best to focus our CEOs so they would be proactive rather than reactive.”

Jim Neary, co-head of global technology, media and telecommunications at Warburg Pincus, said his firm, too, has an institutional infrastructure build up over decades in which the firm has owned more than 500 companies in many parts of the world. As a result, the company’s staff had enough experience to adjust as the downturn took hold. “To say we had seen it all is quite true,” he said. “[The economic crisis of] 1975 was horrible. 9/11 was horrible. This is horrible, but all those lessons [are] learned over time [and] our industry, which was very young in the late 1960s and early 1970s, has matured in recent years. Bringing resources aggressively to bear on the business is something we were able to do in this crisis.”

Neary said executives in his firm always spent a lot of time talking to the management of portfolio companies but are doing so more often now. Perhaps some of the added attention is possible because there is little new business to distract the partners, he added. The most important issue, for the companies is liquidity. “You can get through a crisis if you have liquidity,” according to Neary. “So we are making sure our companies are well capitalized and not overleveraged, or if there is

leverage that it is benign or long-dated. We are shoring up balance sheets where needed.”

Greg Mondre, co-head of Silver Lake’s North American business, said that if a buyout firm buys good businesses, then it must stand by those businesses in a tough period and remain ready to invest more capital to maintain growth. If on balance it makes sense to consolidate, then a decision based on that judgment should be made more quickly today than in a different economic climate. “We’ve done a lot of portfolio pruning as well as major acquisitions and consolidations,” he said. “We focus on core consolidation where necessary and on having much stronger companies coming through the other side of this crisis.”

Perry Golkin, a partner at Kohlberg, Kravis, Roberts & Co., said that in a tough economy buyout firms should become proactive in working with the boards of the companies they own to help them make the difficult decisions. He used the example of a semiconductor company in the KKR portfolio. The industry’s dire condition in the crisis became a reason to override traditional obstacles to making changes in production. “When selling falls off a cliff you have the opportunity to consolidate factories,” he pointed out. “You can take a very bad environment and do some important things to set the stage for future success.”

Future Returns

Gultekin also asked the panelists about expectations for returns in private equity going forward.

Reses said that in the past two years many provocative statements have been made about the death of private equity. “It was a great storyline at the depth of the crisis, but I don’t think you will see firms failing by the wayside,” she noted. “You will see the resilience of the industry as a whole. Some of the larger firms will be a bellwether for that resilience.”

She said many of the major buyout firms acquired large, market-leading companies with “many levers to pull even in the worst times.” As a result, she pointed out, there are many ways for these portfolio companies to survive. One upside of the boom years is that much of the private equity financing in place has few or no

covenants, allowing more breathing room for companies to make it through the cycle.

Neary told the audience that private equity is in the business of pricing risk. He said Warburg Pincus has varied investments by size and, in the smaller companies, leverage is not an issue. He said he is working closely with growth companies — which is what the firm’s investors pay it to do. Private equity will continue to pay investors superior returns compared to alternative investments, he predicted. “Whether that’s 500 to 1,000 basis points better than the overall market — we try to do better than that — but if we deliver a premium that’s great.” Neary’s firm works on a broad range of companies and in some cases can generate a rate of return of 50% to 60% while “bond-like” leverage buyouts provide rates in the low 20 percents.

Mondre said his firm has not had any companies enter bankruptcy, and a few highly successful deals will emerge as the economy recovers, although overall it will take longer for returns to come in than they have historically. Private equity takes longer to determine returns compared to hedge funds or other types of investments because capital is typically locked up for six to 10 years.

When it comes to new deals, Neary said his firm is using its large institutional footprint to find new opportunities overseas and in emerging industries. Successful private equity firms do not wait around for a banker to come to them with a company that needs new equity. Instead, private equity firms must continually look for new areas of growth and be opportunity driven by identifying dislocations in existing markets, as well as nurturing networks to generate deal flow, according to Mondre. The current environment is an “interesting time” for deals. “It’s exciting in some ways and dangerous in others.” He explained that prices for businesses should be good as the economy comes up from the bottom of the business cycle. “Historically, the best deals are done coming out of a crisis. “Leverage is lower, growth is higher. Leverage and the purchase price are aligned. So this could be a good period.”

However, he continued, private equity managers remain concerned about the broader global economic environment. Investors are sitting on a lot of capital and pressure is building to

find places to invest that money. “I’m a little concerned that leverage has come up too quickly, and with the pressure to get deals done, some multiples don’t reflect what has gone on in the past couple years,” said Neary. His firm’s investment approach is like a barbell. On one side are investments in growth properties that may be higher multiple and lower leverage but with the potential for growth that is not cyclically driven. For example, the company joined other private equity firms to acquire Skype, the Internet communications firm. He said the company is well-established, but has tremendous opportunity for more growth worldwide. On the other side of the barbell, he said, are underperforming companies that can benefit from Warburg Pincus’ in-house operational capabilities. “What we are not going to do now in this environment is pay a high multiple for a business that is growing at a slightly higher rate than GDP. That’s a scary place and we will see some auctions now that look a lot like that.”

Gultekin said that it seems clear that 2010 will be a slow-growth year and asked what strategies large leveraged buyout firms will use to adapt.

“You look for the best opportunities you can,” said Golkin, “but there are times when the best strategy is to accept where you are in the cycle, run your business as tightly as you can and wait for the cycle to turn.”

Reses said that her area of specialty, media, is a “tale of two worlds.” She is bearish on parts of the industry facing structural challenges, such as consumer magazines, books, radio and network television. At the same time, there are emerging parts of the business — such as information service and digital media — that are consuming a lot of her time. “In those businesses you can see a path for the next 10 years,” she said, pointing to online education as an example.

Neary, too, said his firm has been negative on traditional media in the United States for a decade. Most of the portfolio companies in his fold are actually what he considers to be data and information services businesses, or new media companies linked to the Internet. He said Warburg Pincus also has an online education business that’s been successful in the current cycle.

Mondre said there are often good companies in out-of-favor industries that can generate returns if private equity’s timing is right. He noted that investors would have made a lot of money purchasing debt securities for traditional radio in the past few months. “It’s all a question of your horizon,” he added, “although it is helpful to have the industry trend behind you, not ahead of you.”

Lessons from the Crunch

Finally Gultekin asked what lessons leverage buyout firms had learned as a result of the crisis.

Golkin said the most important lesson is that the past repeats itself. “Nothing is new about this crisis, but people tend to forget the lessons of the past,” he said. Private equity investors need to pay attention to their capital structure and liquidity, he warned. “You have to be prepared for what you don’t know is around the corner. If you remember the past — which will repeat itself — you are better prepared for macro things that you can’t control. But if you work hard on the things you can control, you will do better.”

Mondre said the crisis has made the dangers of “vintage risk” more apparent. Vintage risk occurs when firms commit too much capital in a year that could be the peak of the cycle. Indeed, 2007 was a strong vintage with \$575 billion in capital invested in private equity. By contrast, \$43 billion was invested in 2009. Most 10-year funds invest over five to six years and should try to diversify over that time.

Another lesson private equity firms have now learned is that it is harder to make decisions when multiple firms are involved in a deal, according to Mondre. At the peak of the private equity boom large firms combined in so-called “club deals” to amass billions of dollars to take major firms private at premium prices. “Decision-making is easy when everything is going well and a little more difficult when things are not going well.” When a business is deteriorating, decisions must often be made to change management or take other actions quickly to preserve value. “What people have found is that a smaller number of firms in a given deal make the decision-making easier.”

Neary said his firm tried to “stick to our knitting and resist the temptation of the loose capital and becoming something that we fundamentally weren’t.” The company’s basic model is to find good businesses, understand their pricing and risk and then make a decision about an acquisition. “We shouldn’t let too many externalities change that fundamental premise and get in the situation where capital markets are throwing more capital at you [and] you begin to change the way you think about risk and reward. Leverage is risk,” he continued, “and [it] adds more risk when you add more leverage. I think there was a moment in time that our industry forgot that we have to pay every penny of that debt. That it’s not free capital.”

The most important lesson, according to Reses, is to “know your partners.” Complex private

equity transactions today involve a wide range of people, from underwriters to investors, who may have different motives. “One observation I have from this period is that you should understand the incentive of your investors and make sure you are aligned and thinking about the long term.” She said that her firm tried to preserve long-term relationships, while others in the business “took the short-term view of getting the last dollar.” A long-term approach, she said, is important to riding out down times like the current market.

“Private equity did a lot of things right,” she continued. “As an industry we were very focused on giving management the tools to succeed in the crisis and focused on cost control. I think that served us well as an industry and that’s not something that should be forgotten.” ✨





Private Equity: Part of the Crisis or Part of the Solution?

Panelists at the recent Wharton Private Equity and Venture Capital Conference considered whether private equity (PE) was a key contributor to the financial crisis — or a scapegoat — and also looked at what role it might play in a recovery. Some argued that if the reputation of PE was damaged, it was largely as a result of miscommunication with the public rather than any serious flaw in the model. Others felt PE insiders needed to reassess their practices in order to be an effective part of an economic recovery.

In the wake of the global economic collapse, the past and future of PE investments were the topic of a conference panel titled, “Alternative Investments: Strategies for the Future.” Moderator Mark O’Hare, founder and managing director of Prequin Ltd., with offices in London and New York, began by asking panelists whether they believe that PE was at the root of the economic crisis or will be part of a solution to problem.

“Regulation needs to balance between helping and curtailing recovery. In the right circumstances private equity can be a solution or at least part of the catalyst to change.”

Mark O’Hare, Founder and Managing Director,
Prequin Ltd.

“To some extent, private equity is a scapegoat,” said Chris Ip, managing director of private equity at the University of Pennsylvania’s Office of Investments. “When they look back maybe some of the deals were excessive in terms of leverage, but the banks were the ones that signed off on it and the rating agencies have some fault as well. No doubt private equity got ahead of itself, but to blame private equity for where we are today is a little bit unfair.”

Ip said PE can help revive the economy. “But it’s not that simple,” he continued. “There are a lot of other constituents and stakeholders that need to step up. Bankers need to step up. Lenders need to step up. And regulation needs to balance between helping and curtailing recovery. In the right circumstances private equity can be a solution or at least part of the catalyst to change.”

Garrett Moran, senior managing director and chief operating officer of corporate private equity at The Blackstone Group, said the PE model allows companies with well-aligned management, boards and investors to make decisions to acquire firms quickly and with a “crystal clear agenda. That’s why public company managers clamor to come to private equity.” Managers backed by PE can add value to companies through strong execution and focus. Problems in the leveraged buyout industry stem from a misalignment in governance throughout the industry, he said. The main problem is a systemic separation between loan originators who were in the business to collect fees and banks that would hold the debt longer term.

“That was a moral hazard in the buyout business, but it was a problem 100-fold in sub-prime lending,” according to Moran.

David Ingles, a partner at the New York City law firm Skadden Arps Slate Meagher’s financial institutions group, said that in the past two years PE has been increasing its position in the financial sector dramatically. “We think private equity is part of the solution.” He said his group is working to bring badly needed new investment to the financial industry, but finds firms are fearful that regulators will introduce structural changes that will alter deals two or three years from now.

A Communication or Over-leverage Problem?

O’Hare asked if PE has done a good job of communicating its value to the economy, given the criticism it has faced as a result of the crisis.

Moran noted the industry has formed a lobbying organization, the Private Equity Council, to spread more information about the asset class and improve its image. He said it is difficult for “the average newspaper reader” to understand the structure and role of PE in the economy. The industry organization has struggled with whether to focus on getting its message across to a broad audience, or to concentrate its message on “influencers.” So far, he said, the industry has targeted politicians in Washington, D.C. and regulators. He noted that some labor organizations have blamed private equity for the economic problems their members are experiencing.

“We need to get out there and tell our story,” he said. “I would say we get a C-minus so far.”

Sebastien Burdel, a principal with Coller Capital Investment, which has offices in London and New York, said private equity has to “look in the mirror and admit we did over-lever and as a result overpaid. The benefit fell to the seller, not the buyer. That said, I would agree we are bound to be part of the solution,” he continued. “Forget about leverage; what private equity is all about is taking an asset out of the public, short-term focus and allowing you to be more opportunistic.”

He predicted that private equity-backed companies will grow at a faster pace in 2010 than the Standard & Poor’s index, “because management can be focused on taking the right actions at the right time.”

O’Hare said there seems to be two opinions emerging on the future of private equity. The first is that the model is broken. He pointed to a Boston Consulting Group study that estimated up to 40% of private equity firms would close down in the next several years. On the other hand, private equity returns over the past 12 months are relatively good. “Most investors, even if they can’t invest right now because of constraints, are by and large pretty satisfied. Even if they can’t commit new investments they are sticking with the program.”

Burdel’s firm conducts the Coller Capital’s Global Private Equity Barometer of investor attitudes toward private equity. In December, the survey found that about 70% of private equity limited partners planned to keep their investment the same. Twenty percent planned to increase their allocation and 10% expected to decrease their exposure to the category. Burdel added that investors are ratcheting down their expectations for private equity returns to where they were about five years ago. “If you ask me that’s healthy,” Burdel noted. “I’d say limited partners are cautiously optimistic about the asset class. They will be more selective about the reputation and allocation to management but that is healthy and sets up the industry for a darn good future.”

Moran said his firm is raising a fund now and small limited partner investors are re-upping. He said that over the past 100 years, private equity outperformed stock markets and top performing firms consistently outperformed the median. “The other thing that’s documented,” he continued, “is that the best returns are always in the years right after a recession. Deal volume is not necessarily the highest, but the best returns are then.”

O’Hare picked up on the theme of asset allocation and asked whether investors are sticking to rigid models that set hard percentages for private equity investments. “It seems to me the more sophisticated institutions are taking a more

pragmatic view and there are no set buckets of assets,” he added.

Ip said that for long-term investors, like university endowments, private equity will continue to be part of the asset mix. “In the short-term, private equity is not the flavor of the month,” he said, “but it’s a long-term game and we intend to be in the asset class a long time.”

O’Hare asked Ip whether limited partners feel their interests are in alignment with private equity managers. Ip said limited partners do pay attention to alignment issues, particularly how much of the fund’s revenue base is derived from capital accumulation and how much comes from fees. “When it comes to alignment I would put it at a C plus — there is certainly room for [more] alignment,” according to Ip.

Burdel said limited partners will pay for performance regardless of whether the deal is structured in the American-style with “carried interest,” or profit sharing, going to the general partners earlier than in Europe, where typically all committed capital plus a hurdle return rate needs to be returned to the limited partners before any carried interest is paid. “All these terms are negotiable,” he pointed out. “There’s a pendulum that’s swinging depending on demand between general partners and limited partners. It will keep swinging back and forth as long as there are business negotiations.”

Three or four years ago, the industry talk was about getting access to funds and investors didn’t care much about the terms. Now, in the wake of the financial crisis, the pendulum has swung in the other direction and limited partners are focusing on terms “because they can,” Burdel added.

The Value of Operations

O’Hare then asked the panelists how much of the industry is based on leverage, or as private equity professionals insist, their superior ability to manage portfolio companies. “Is that the reality or is lip service when you talk about operations?” he asked.

Moran replied: “I think leverage is great but it is only for adults and should be closely supervised.” He said Blackstone will continue to raise large funds but they will be closer in

size to those that the firm managed before the boom years. [Blackstone announced a successful \$280 million initial public offering on May 27. The Blackstone/GSO senior floating rate term fund’s “primary investment objective is to seek high current income with a secondary objective of preservation of capital, ...” according to the company.] As for operations, he said that in the last six or seven years Blackstone has developed its own internal infrastructure to improve operations at the companies it acquires. In addition, the firm has increased its global footprint providing expert staff in parts of the world that provide new access to investors and potential acquisitions.

Moran used the example of the Nielsen Company, which was acquired by a group of large private equity firms, including Blackstone, in 2006. The private equity owners installed a CEO from General Electric. Moran said customers liked Nielsen’s services so much they were “addicted” to some of them, but that delivery was sometimes “helter-skelter.” The new owners consolidated operations, such as human resources and purchasing, but went beyond those quick fixes to drive a lean initiative throughout Nielsen’s organization, eliminating excess layers, processes and people. “They had a great product but had become lazy,” he said. “There are a lot of companies out there like that.”

O’Hare said financial services appear to be the biggest opportunity for private equity in the economy at the moment and asked Ingles about obstacles to expansion in the sector. Ingles said private equity firms are expressing interest in the financial sector because there are many failed banks and bank deals in need of finance and restructuring. Pricing, he noted, is at a cyclical low in the financial services sector.

“Private equity firms that are able to get in and make good decisions, notwithstanding the limitations of the bank regulatory structure, and put some strong management in, can make a lot of money,” according to Ingles.

He cautioned that private equity firms must be mindful of regulations governing the ownership stake of banks. Investors are limited to a maximum of 25% ownership of voting equity in financial institutions. If they go over that amount,

they are considered to be a bank holding company and are prohibited from owning anything other than banks. "Private equity is much more diversified than that so to cross that line would be disaster," Ingles said. "Private equity firms have to be careful to remain in a neutral position."

O'Hare then asked the panelists what other industries might provide opportunities for private equity in the future. Ip said energy and natural gas investment might be interesting, but he said he is not a fan of [investing in] clean technology. He said his office prefers to put capital into areas where others have done well and are expanding markets. "It really is about a good management team and sometimes it depends on the cycle. In the right opportunity, private equity can work in most industries," he said.

Moran said that while most conventional funds have extended into more esoteric areas such as energy and finance over time, clean technology remains more "venturish." His firm has done lending to support a business launch in energy although it has not backed any clean tech. However, he said partners are looking into the power and forestry industries.

Burdel said firms can weigh liquid against illiquid investments in hedging risk. "It's a great opportunity for private equity managers to compete against each other with the same risk portfolio," he said.

Moran finished up the panel noting a trend at his firm of seeking out opportunities by blending investments in sectors that might not appear to be linked. For example, he said, Blackstone now operates a real estate investment fund that was once part of its corporate business. Now the firm is looking at companies with real estate assets in addition to their core business, such as nursing homes and hospitals. The company shied away from movie theaters when the real estate partners warned that repurposing those assets would be impossible.

He also noted that the corporate investment team worked with the firm's credit arm in structuring its acquisition of The Weather Channel. They provided the credit and Moran's team came up with the equity. "We do a lot with real estate and credit," Moran said. "It gives us the ability to do other things and gives us an internal fraternity of people that makes it more fun to work there. Looking at combined private equity and real estate investing is better than either standing on its own." ✨





Expect Europe's Private Equity Market to Contract

In a keynote speech at the Wharton Private Equity and Venture Capital Conference titled, "A New Dawn: *Investing in the Post-Crisis World*," Dalip Pathak, manager of Warburg Pincus' London office, which oversees the firm's business in Europe and India, offered a global view on the economic crisis and private equity's role in capital investment around the world going forward.

Pathak said that the crisis comes at a time when the entire world economic order is being restructured with new emerging powers, including China and the other so-called BRIC countries — Brazil, Russia and India — leading to even more uncertainty than would have come with a typical business cycle.

"We are not in a situation of stable equilibrium. We are in a very dynamic situation and it is going to stay that way. We have to think of our business model in that context."

Dalip Pathak, Manager, London Office,
Warburg Pincus

"China and the other BRIC nations are confounding the ability to forecast cycles," he said, explaining that in addition to the hard down cycle, investors now have to try to factor in the impact of new economic forces. "The world is restructuring and will continue to restructure. We are going through a period that is internationally challenging

and there are victims to the restructuring," said Pathak. "We are not in a situation of stable equilibrium. We are in a very dynamic situation and it is going to stay that way. We have to think of our business model in that context."

He added that private equity investors must stress test their models because "nightmare scenarios do exist and happen more frequently than you expect."

Pathak, who was chief of mission of the World Bank's International Finance Corporation Thailand before joining Warburg Pincus in 1994, then ticked off a list of crises that have rocked financial markets over the years. He pointed to the dissolution of Soviet Russia, the Asian financial panic, the U.S. dot.com bust and, most recently, the possibility of sovereign debt defaults in Greece and other European nations. "Even though these downturns happen every three or four years, somehow we forget about it or we ignore it."

As a result of the crisis, Pathak said that the private equity industry will certainly contract. In Europe, there will be fewer firms managing somewhat smaller funds. Firms will need to put more equity into deals. "In the longer term, the industry will return to growth and the survivors will be better companies in a sense," Pathak predicted. "They will have the dry powder and [be] better managed. [It] will be a better industry."

Private equity remains a relatively young industry in Europe and will grow stronger in the future, although current returns are driven by investments made at the peak of the private equity boom in 2006 and 2007 and are "not

great," he pointed out. "We hope '09 and '10 will be great," he continued, noting that "the assets we are seeing now are pretty interesting" although in some sectors the market seems to be ahead of itself.

Pathak said that he keeps hearing that "Europe is finished," but he countered that because Europe is the largest market in the world, even a slow growth rate of 2% a year would provide more incremental earnings than 8% growth in India. "While people are all excited about India, there is a lot of intellectual property in Europe. There are great universities and high-growth subsectors." The economic downturn, he added, is feeding growth in value retailing, online retailing and outsourcing businesses.

A Change in Leadership

A generational change in leadership is underway in European private equity companies for a number of reasons, Pathak said, predicting that the churn will continue in the current year. The main reason, he explained, is that some firms made huge mistakes and limited partners "are upset and need a scapegoat. They are not willing to pony up the money for new funds unless there is some indication of change at the top."

At other firms, managers are stepping down because they feel they have made enough money and the last downturn was such a "major shock" that they need time off. When the person at the top leaves, he observed, their protégés also tend to leave, sometimes to start their own funds. As a result, growth-oriented funds are hiring.

As for investment opportunities, many firms are focusing on follow-on investments in their own portfolio where some managers are looking for new capital to make opportunistic acquisitions. "Those are the investments they know best," Pathak noted. And European firms are now starting to follow the trend of taking a minority stake in companies, which began in India and spread to the United States. Growth opportunities still exist in Europe, he insisted, adding that "forecasts of the death of European private equity are premature." Opportunities exist for PIPE financing (PE company investments in publicly traded companies) and buyouts, but without much leverage, he said.

However, "the fundraising environment is tough," Pathak conceded. Companies are still raising money, but few are closing funds. "There was a significant panic of limited partners. Limited partners are liquidity focused and appreciate distributions, and I think the industry is focused on making these distributions. If the distributions are not forthcoming, the LPs don't have money to put into funds." He predicted that in the next two to three years, funds will start flowing into new allocations.

"The most bizarre thing is that for some reason the European regulators have decided to come down heavily on this industry," he said. Regulators have proposed some "fairly absurd" rules in the wake of the financial collapse and the industry is waiting for more clarity on exactly what new rules will emerge.

To put his overall comments into better context, Pathak offered an overview of Warburg Pincus, which was founded 40 years ago and has already weathered many economic slumps. He said, "In every downturn, liquidity is key — liquidity in the investment companies and liquidity in the firm." Warburg Pincus has enough cash to "coast" for three years, he said, in part due to its diversification and expertise in industries such as energy and health care.

"We have made a lot of money in the past five years in energy. Health care is also resilient," he said, noting that valuations for health care companies in Europe have dropped by only 5% because of the crisis. And as the population continues to age, he maintained that health care will become even more important.

Warburg Pincus is not a major leveraged buyout firm, which also protected it from the worst of the global crisis, said Pathak. "This has served us well, but this is not to say other models do not work," he noted.

He added that the ability of Warburg Pincus to weather the crisis also has been largely due to its major positions in Europe, China and India. The firm was an early entrant into the Asian market. "We have a dominant position in these markets and India and China have to some extent significantly saved us," he said.

Crisis in Europe

Pathak then turned to the crisis in Europe, noting that the boom in European private equity finances between 2003 and 2007 was driven by leveraged buyouts fueled by liquidity. As loan volume increased, so did the number of buyouts. “The world has been awash in liquidity for many years, primarily driven by imbalances in the world with the rise of China and the surpluses in the Middle East,” he said. “The Western world has not managed it that well.”

As leverage buyout activity increased, deal values grew increasingly larger and were financed by larger loans, he explained. “Most of us who have dealt with banks in Europe literally had to say to the banks, ‘We do not want to take this money.’” When banks offered to finance deals at eight times EBITDA (earnings before interest, taxes, depreciation and amortization), he said, private equity firms agreed to finance at six times EBITDA. “Most of the firms in Europe have been fairly thoughtful and are in good shape. We didn’t take all the money thrust upon us by the banks,” he said.

At present, deal flow is picking up and Pathak said his firm is now busier in Europe than it has been for several years. He noted that Warburg Pincus sat out on much of the deal-making in 2006 and 2007 because of concerns about market conditions. The firm largely pulled back from new deals and limited financings to companies already in its portfolio.

“Despite the uncertainty, I’d rather be in today’s market than the one in 2006 and 2007,” he said, adding that a large backlog of assets that sat unsold in the past two years because of the crisis will have to come onto the market soon to return investments to partners. “Private equity has to sell,” he said. “Big private equity is driving the disposals.”

Another factor driving the sales is the changing tax policies in the United Kingdom that will encourage investors to sell assets. However, just as more assets come on the market, competition for transactions is sharply reduced because banks have cut back on financing for highly leveraged sales.

Today, there are fewer private equity players in Europe than there were during the boom years and some firms are running out of cash, Pathak said. Meanwhile, the environment for raising cash is strained and private equity firms are holding back on new investments. At the same time, valuations are better and financing has improved since the depths of the crisis in late 2008. Debt financing will remain limited for the next three to five years, he predicted.

The high-yield bond market has already regained strength in the United States and is now picking up in Europe, he noted, although a lack of bank interest in providing bridge financing makes bond placement more difficult. “Some of us are capable of and willing to fund certain deals with 100% equity,” he said, stressing that liquidity is key.

Looking back on the crisis, Pathak said that he saw how good management is critical to survival in a downturn. “We have in our own portfolio [a mix of] companies. One is falling off the cliff and the other is hanging in there over the last few years, due less to the sector and more to the competence of management. Good managers figure a way out.”

He added that he also learned from the crisis that “unpredictable dislocations do happen.” Companies must always build in a margin of safety for events that cannot be expected. “Don’t think that just because you have assumptions and have validated the assumptions that something you haven’t thought of isn’t going to cause a problem,” he said. “The virtuous cycle of leverage and valuation does not last forever.” ✨





Private Equity Opportunities in Emerging Markets Could Help Offset a Slow Recovery Elsewhere

While the United States and Europe were hit hard in the global economic crisis, many emerging markets have fared better and private equity investors may be poised to benefit from new opportunities overseas. But these markets are in different stages of maturity and each has unique opportunities and potential pitfalls, according to panelists at the recent Wharton Private Equity and Venture Capital Conference.

The conference, titled “A New Dawn: Investing in the Post-Crisis World,” covered a number of topics, including a panel on the state of private equity in emerging markets. Wharton senior fellow and lecturer, Stephen Sammut, moderated the panel, asking the speakers what limited partners are looking for from private equity (PE) firms in their markets and if those demands have changed following the global economic crisis.

Veronica Lukito, co-founder and managing director of Ancora Capital fund in Singapore, said that Indonesia is a nascent market for PE. This form of financing began to evolve in Indonesia after the 1997 Asian financial crisis, she noted, adding that it took five years for the country to recover from that panic.

Natural resources are a key focus for the fund, she continued, with Indonesia a major exporter of coal, palm oil, gold, tin and nickel. The country is a net importer of oil and natural gas, but Indonesia has the potential to develop these resources internally in the future.

At the same time, she said, the fund also has new opportunities in the domestic market. With a population of 240 million, Indonesia is the

fourth-largest country in the world. “Coming out of the 2008 crisis we have been more resilient because of our lack of dependence on exports compared to Malaysia or Singapore,” Lukito said. “Indonesians want to develop their exports, but also build new markets at home. We have the best of both worlds.”

Lukito also said limited partners are asking how a slowing Chinese economy would impact Indonesian investments because Indonesia is a major exporter of coal and natural gas to China. “All I can say is that Indonesia has room to grow,” she said, explaining that political reforms in Indonesia are stimulating internal growth such as the construction of power stations. “We expect that we will have internal consumption to rely on in the next few years.”

“Indonesians want to develop their exports, but also build new markets at home. We have the best of both worlds.”

Veronica Lukito, Co-founder and Managing Director, Ancora Capital Fund

Brazil and Russia

Patrice Etlin, managing partner of Advent International in Brazil, described his market as “fashionable” at the moment. He recalled that American private equity investors surged into Brazil in the mid-1990s in part due to confidence in the nation’s currency after the real, and the

peso in neighboring Argentina, were pegged to the dollar. "Of course nothing happened," he said. "There were massive devaluations in Brazil and in Argentina," and capital markets took 10 years to recover from related recessions. Limited partners, he said, turned their back on the region in favor of pursuing new opportunities in China and India. Only a few general partners remained Brazil.

Now the country is experiencing a new wave of interest from PE investors. However, Etlin pointed out that managers of large pension funds may be reluctant to rush back into Brazil. Pension fund managers tend to remain in their jobs much longer than hedge fund managers and other investors who quickly move in and out of capital markets, and who therefore may not have been in the industry in the 1990s. The pension fund manager, said Etlin, "will always remember he burned his fingers in the mid-90s in the region."

While there is excitement about Brazil, few funds can show a track record in the region, Etlin noted. While that means his firm faces limited competition, he said it is still difficult to raise sizeable amounts of capital because of large investors' past experiences in the region.

Dmitri Elkin, managing director UFG Capital Partners in Russia, said his market is viewed as one of the riskiest in the world for private equity investments. When the crisis hit global capital markets, many investment managers were suddenly seeking safety. Russia was the "first country that got crossed off the list," according to Elkin. "It was a dramatic change."

Now there are only about a half dozen specialized private equity firms operating in Russia. Those few remaining firms now enjoy better access to deals, but it is difficult to raise funds. Russia has returned to being a small private equity market with a few players and "reasonable valuations," said Elkin. By contrast, he pointed to an incident in 2006 that jarred the traditional notion that returns in emerging markets were discounted because of the greater risk. He recalled his surprise at hearing a young banker in Russia's then-hot investment climate refer to an "emerging market premium."

India and China

Shifting the focus to India and China, Sammut questioned panelists about raising capital and how risk is perceived in those emerging markets. "Is it as easy as it sounds?" he asked. "Is it as hot as it is perceived?"

Naveen Wadhwa, who heads TA Associates' Mumbai office, said that like Brazil, India is a "very sexy story." She explained that the market in India is well understood by limited partners who know about positive demographic and consumer trends in the country along with deregulation that is improving business conditions. "India is an exciting story and limited partners get it," said Wadhwa. "Capital is very available for India."

However, limited partners also are struggling to find investment firms with a track record in the country. While India's capital markets are mature for Asia, they are still just emerging when compared to the rest of the world. "Only a handful of firms have seen a full investing cycle in India," Wadhwa said. Finally, she noted that companies go public much earlier in India than in other countries so there is more competition between private equity and public markets. There are a lot of opportunities for investment firms "that are nimble enough to play both," she added.

As for China, Richard Zhang, managing director of Apax Partners and head of its Greater China business, called it a "gigantic paradox."

He focused in on two words in Sammut's question: "hot" and "emerging." He said the paradox is that both describe private equity markets in China. First, he confirmed that China is "red hot," even "iron hot." Everybody is rushing to China and India. "All limited partners want to increase their exposure. Liquidity is abundant," he said.

At the same time, Zhang emphasized that China is still an emerging market. Many entrepreneurial companies are in the very early stages of development and while the volume of firms starting up is high, each company is quite small. The average deal size in China, he noted, is only \$50 million. He observed that a wide range

of types of funds are doing business in China, including Asia funds, venture capital, and larger buyout funds. Corporate entities are operating in China as if they were private equity funds.

“I think the question on risk perception is extraordinarily important,” Zhang continued. “The good news is that there is significant money in China and I think it is clearly a market that will remain very big and will continue to grow. The jury is still out on what investment model will be most successful, but probably they [more than one] will coexist.”

Zhang added that he is neither completely optimistic nor pessimistic about the market. “The truth is there is a lot of complexity, a lot of nuance. The devil is in the details in China — to identify where the real risks, upsides, and price are to make the risk adjustment work.”

Sammut noted that he recently spent a month in China and sensed that the government is growing increasingly uncomfortable with the structure of offshore investments and the prevalence of dollar-denominated funds. He asked Zhang if he thinks the government might begin to push for investments through renminbi (RMB) funds.

Although he isn’t certain that the government is advocating RMB funds, Zhang pointed out that China is selective in attracting foreign funds and funds denominated in dollars and other foreign currencies are subject to certain limitations in China, which are no different than any other foreign investment in the country. “The emergence of the RMB fund as a phenomenon will continue to grow,” he said, but added that he does not think that continued growth of RMB and

dollar-denominated funds in China are mutually exclusive. “Doing both raises some conflict-of-interest and coordination and governance issues, but in general the rise of the RMB fund is a long-term trend,” Zhang predicted.

Kosmo Kalliarekos, who manages Baring Private Equity Asia in Hong Kong, a pan-Asian private equity investment fund, said the bulk of the firm’s investments are in India and China. He agreed with other panelists that while limited partners are eager to take positions in the region, there are not many experienced funds in operation. Of approximately 250 funds currently active in Asia, two-thirds are first-time funds that started after 2005. The funds also tend to be small, he said, noting that no more than 10 pure Asia funds have assets of more than \$1 billion.

While limited partners are eager to invest in Asia, Kalliarekos commented that they have a difficult time choosing which fund to use. Since most funds now in operation were established between 2006 and 2008 — and have not yet made distributions — there is not much of a track record on which to judge fund managers. “Investors are coming and they are excited,” he said, “but the limited partners in particular do not have the infrastructure to cover Asia although they are building it out.”

So far, he added, a significant amount of recent PE investment in Asia was through hedge funds and the proprietary trading desks at Wall Street firms, which has largely exited the market. “If you have returns you will be able to attract funding. It’s there. They want to invest. It will be interesting to see how it plays out over the next three years,” he said. ✨





Is China Private Equity's Next Rock Star?

The future of private equity is in China, said the leader of one of the world's largest private equity firms. Robust economic growth, abundant opportunities, little competition, and a positive government attitude make China one of the most appealing countries in the world today for private equity investors, David Rubenstein, co-founder and managing director of The Carlyle Group, said at a recent Wharton forum. China is also setting the pace for global private equity by investing large amounts of capital outside of its borders, he added.

“China will probably be the trend setter, and really the epicenter of private equity in the next five to 10 years.”

David Rubenstein, Co-founder and Managing Director, The Carlyle Group

“I think for those reasons, China will probably be the trend setter, and really the epicenter of private equity in the next five to 10 years,” Rubenstein told the audience at the Seventh Annual Wharton China Business Forum 2010, “Recovering from the Crisis: A Look into China's Future.”

China has roughly 20% of the world's population and is now the third-largest economy, said Rubenstein, who served as deputy domestic policy advisor to President Jimmy Carter before starting The Carlyle Group in 1987. Depending on how it is measured, some say China is already the world's second-largest economy, and soon,

China will pull into first place, he predicted. “China was the largest economy in the world for 15 of the last 18 centuries, until the 1700s when Europe came along and replaced it,” Rubenstein said. “The United States has been the largest economy in the world since the 1870s. We will lose that title in roughly 2035 or 2040, depending on how you measure growth. And then China, for the rest of this century, will be the largest economy in the world.”

The numbers are dramatic, although some observers are uncomfortable with the economic statistics that come out of China, Rubenstein said. Actually, there are two schools of thought: One school says that China underplays its economic growth; another said China overplays it. “Nobody really knows exactly what the right numbers are. Sometimes people say the Chinese government officials aren't certain themselves. They tend to look at electricity consumption as the real measurement of economic growth because that's something they know they can really put their fingers on. I would say it's pretty likely that the growth is around the 8% to 10% range.”

While the recession has dampened China's growth somewhat, the country has shown “amazing resilience” through the recent economic turmoil, making it the darling of private equity investors. “Even in the last few years, as private equity investment has gone down in other parts of the world, in China it has been going up,” Rubenstein noted. The investment has not been concentrated in one region or sector, he pointed out, but over a range of industries in all parts of China. “The money going into China is not just going into the

coastal areas,” he said. “The government has been very happy with this development.”

Autograph Requests

“What makes the Chinese government encourage companies like The Carlyle Group to come invest there? “It isn’t capital,” Rubenstein said. “China does not need foreign capital. They have \$2.4 trillion in foreign reserves ... It’s the management that private equity firms have ... I think the government is trying to get contacts, expertise, technology and skill sets, not capital.”

The image of private equity is better in China than probably any country in the world, Rubenstein noted. “When I’m in Washington D.C., people are barraging me, [saying that] I’m not paying enough taxes, I’m not worried enough about labor concerns. I’ve got labor unions protesting me. I’ve got everybody telling me that I didn’t do something right. In China, people want my autograph. In China, private-equity professionals are like rock stars. Because China has taken the view that private equity is a value-adding technique and a value-added resource, they encourage it.”

For Rubenstein, the irony is startling. “If Richard Nixon and Mao Zedong came back, they wouldn’t know which country was which. Honestly, I tell people — though I don’t like to get quoted saying it because I get in trouble — the center of capitalism is Beijing, the center of non-capitalism is Washington, D.C. Now obviously, that’s an exaggeration to make a point, but there’s no doubt that in China, what private equity people do is very much welcomed and not criticized,” Rubenstein asserted. “Right now you see more intervention in the economy in the United States than you do in China. It’s an incredible role-reversal. I never thought it would happen.”

Looking back, it took a while for private equity to reach China, said Rubenstein, who offered a synopsis of private equity’s history there. While the world generally considers the term “private equity” to mean buyouts, the U.S. uses the term to refer to both buyouts and venture capital, he said. The venture capital business in the U.S. started on a small scale in the 1960s, usually with investors putting down 20%. It expanded in the 1970s with what was known as “bootstrap deals” — when investors put down 5% and borrowed the rest.

Private equity first entered Asia around that time, Rubenstein noted, but most deals were small, based in Hong Kong, and controlled by banks or insurance companies. Private equity investment in Asia took off in the 1990s, when the 1997 Asian Financial Crisis left many Asian companies in need of capital. But it was not until the turn of the century that private equity investors began to show a real interest in China as the government warmed to more foreign investment.

Opportunities Are Growing

Despite the increased interest in China, especially in the past five years, there is still a relative lack of private equity competition there, Rubenstein said. “In the United States, private equity as a percentage of GDP is 3.4%. In China it’s 0.2%. As a result, you can say there’s enormous opportunity there because it’s still a very small percentage of the economy.”

China’s burgeoning army of new entrepreneurs are opening doors to new investments, Rubenstein pointed out. And China’s creaky, state-owned enterprises (SOEs) “are ripe for private equity privatization,” he said. There are about 143,000 SOEs in China today and the government probably wants about 500 of them to remain state-owned, he estimated. “That means there are over 100,000 state-owned enterprises that are going to be privatized, and that’s a very good opportunity for private equity.”

Opportunities will also grow as China shifts the focus of its economy away from exports and more towards its domestic market. “I do think as China produces more products for its domestic market, it will transform its economy a bit and probably produce more so-called value-added products,” Rubenstein said. “In the United States, right now, 75% of our GDP is consumer spending. In China, that percentage is roughly 30%. So the Chinese government is trying to get that percentage up and trying to have more domestic consumption. And as it does so, the Chinese economy will grow differently and provide a lot of opportunities to invest in [companies] that will make things for Chinese consumers.”

Going forward, Rubenstein sees China playing an even larger role in the private equity world as it increases its investments abroad. “China is going to set the tone for private equity because

a large number of their sovereign wealth funds are going to be investing large amounts of money outside of China, and they're going to be setting the rules and the patterns for what some of those investments are going to be." To take just one example, China's national investment fund — China Investment Corp. (CIC) — revealed in a filing with the U.S. Securities and Exchange Commission early this year that it owned \$9.63 billion in equity stakes at more than 60 U.S. companies, including American International Group Inc., Apple Inc., News Corp. and others.

"The United States has been the dominant player in private equity for the last 30 or 40 years," Rubenstein said. "China will soon be almost as important as the United States in the world of private equity, and may replace the United

States at some point because of the enormous amount of money that's being invested — not only in China but the amount of money China is investing through CIC and other organizations outside of China."

China is "the great economic story of the 21st century," Rubenstein concluded. "Nobody would have predicted at the beginning of the 20th century that the United States would become as dominant as it did, and even today we probably can't predict how dominant China will be in terms of its economy throughout the 21st century. But given its population, its entrepreneur culture, and capital, it's going to dominate the global economy for most of this century." ✨





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