

Private Equity



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Tough market conditions and ongoing debt funding restrictions in 2009 have seen private equity M&A activity in the first half of 2009 (US\$32.9 billion in announced transactions globally) decline by 78.8% over the prior equivalent period - financial sponsors accounted for just 3.5% of announced transactions during the first half of 2009. PE returns struggled along with other asset classes, with the overall IRR (globally) for PE standing at negative 27%. Even though investors are still keen on this asset class, PE funds will take longer to raise new funds with most attention now being focused on refinancing or restructuring portfolio company bank debt and turning these investments around. Looking ahead, PE investments made over the next few years are likely to generate excellent returns, particularly those investments which incorporate operational improvement opportunities.

In the Asia Pacific region, Australia and New Zealand were the first territories to experience a downturn in PE deal activity some 15 months ago. In China, the market slowed into the fourth quarter of 2008 but is already showing early signs of recovery. In other territories, Japanese M&A has seen some uplift in the financial services space (rather than PE) whilst political instability in Thailand has affected M&A activity levels. Some liberalisation to the Malaysian regulatory environment may have a positive effect going forward as will the presence of new single purpose/focus funds (e.g. Distressed Debt funds and the Islamic Infrastructure Fund).

Deal activity is being hampered by vendors still having unreasonably high price expectations (notwithstanding economic conditions and poor financial performances) and lack of funding availability. Individual lenders' appetite of US\$25 million is limiting deal opportunities to US\$500 million in enterprise value and there is little evidence that the Corporate Bond Market or Mezzanine debt will rebound in the short-term. Equally, whilst there is talk of vendor finance becoming more readily available, this is not yet evident in the market place. On the positive side, there are a number of current deals which offer stapled finance packages, plus renewed interest in PIPE deals. In addition, global PE and sovereign wealth funds have taken cornerstone investments in several blue-chip corporates facing short-term liquidity rather than solvency issues.

Activity in the LBO sector will take a backseat for a while longer, with PE funds' focus remaining firmly on preserving and enhancing value in existing portfolios. Short-term strategic business reviews, cash optimisation initiatives, and strategic option scenario analyses are critical to portfolio companies implementing quick wins to stabilise their performance and restore stakeholder confidence. PE funds are being increasingly proactive in sharing strategic plans with financiers to support the stabilisation initiatives being implemented at their portfolio investments. Capital market valuation pressures and lower EBITDA performance reflecting tightened consumer spending as the global financial crisis continues to impact the real economy will inevitably result in holding periods extending into the 2010 calendar year and possibly 2011 on existing portfolio investments. Some PE funds will have to make difficult decisions around the ongoing support of distressed portfolio investments, with some recent examples of failure. On the plus side, there is renewed trade buyer interest in 2006 and 2007 vintage investments, particularly in the health sector, and a number of dual track sale/IPO processes are poised awaiting for the equity markets to re-open.

In terms of deal flow, PE funds are likely to invest greater equity cheques in deals and increasingly look to complete a higher proportion of non-controlling investments, particularly in small-and-medium sized listed companies which appear to be more realistically priced. The non-controlling investments will be regeared and PE funds will move to control when debt markets recover. In addition, we are likely to see more activity around bolt-ons and secondaries continuing into 2010. There are also some suggestions that larger PE funds could be run on lower percentage management fees in the future.

In 2008, PE funds across Asia were active in the consumer goods, services and manufacturing sectors. We are now seeing more interest in health, pharmaceuticals and infrastructure that offer stable, more resilient cash flows. Whilst we are expecting the next nine to 12 months will generally reflect a continuation of fewer deals, fewer exits, longer holding periods and lower deal sizes than recorded in the 2007 'purple patch' period, fit and agile PE funds will still be able to capitalise on some exceptional value situations - and even those in a weaker investing position will be able to create sustainable value in their portfolio companies.

For the remainder of 2009, PE funds will focus on stabilising their portfolio investments in order to be in a strong position when the market returns to more normal investments and funding patterns. Despite a slow first half in 2009, we expect the deal flow will start to bounce back by mid 2010. However, these deals may be fundamentally different with more minority stakes, more partnerships with incumbent owners, and more co-investments with sovereign wealth funds, other major limited partners and corporates. Those PE funds who adapt to the new investment paradigm will thrive in the new economy. ■