Asset class:
Private equity

Favourable situation for good private equity

- *The private equity (PE) market is functioning again*
- *Increasing supply and attractive prices are providing good business opportunities*
- *Despite uncertainty about regulations and funding, we have a positive view of PE, given good quality selection*

The world's financial markets are continuing to normalise. The existence of the economic recovery is also unquestionable, although its strength – growth dynamic – is open to discussion. This is good news for the private equity (PE) industry and is reflected, among other things, in a good index trend for listed PE companies.

The overall picture in the underlying businesses is also brighter, but at the same time more complex. Parts of the PE industry are still grappling with major problems. Many of the funds/companies that made aggressive, highly leveraged investments late in the economic expansion are still confronting difficulties. Meanwhile business opportunities are unusually good for those investors whose portfolio companies are in good shape and who have money to invest.

Large obligations in the private equity market

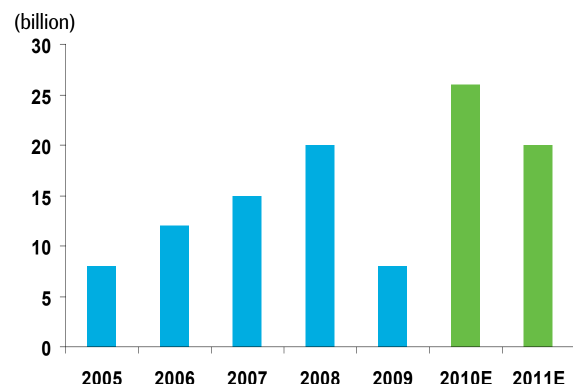
The underlying mathematics is specific to PE investments. As most people know, PE companies (or funds) make their actual investments over a period of years. Investors who participate from the start undertake to deliver money as the fund buys companies. A fund that started during the peak years 2008-2009 perhaps had time to make only one or a few company investments before the crisis hit. This means that many investors still have large remaining obligations to PE funds.

During the 2009 crisis, large portions of the PE market froze completely. Almost no new funds were started, and in the secondary market (trading in existing holdings in and obligations to PE funds), worldwide volume fell from USD 20 billion in 2008 to USD 8 billion. It can hardly surprise anyone that the primary market died out. The sluggishness of the secondary market was not as self-evident, but it was largely because sellers and buyers stood far apart regarding reasonable prices. Meanwhile not so many investors were under pressure to sell, since the funds that started in the years just before the crash, and thus were not yet fully invested, were not active in buying companies. This meant that they were not collecting more capital from their investors.

Various factors behind the brighter outlook

Today the market is rapidly thawing. The funding situation has brightened considerably. Granted that a larger percentage of equity is now required, but there is still a lot of "business as usual" for PE companies. The more positive general economic picture is another contributing factor behind a resumption of acquisitions by PE companies and funds. As a result, more funds are drawing capital from their investors, forcing financially weak investors to give up previously invested money when they are not capable of meeting new demands for capital. This creates a golden opportunity for those who have capital to invest, assuming good talent for identifying quality investments. In these cases it is also an advantage to be well-connected in the PE industry, since some of these holdings do not reach the broad market.

SECONDARY MARKET TAKING OFF



The secondary market for private equity froze during the 2009 crisis. An unexpectedly rapid recovery is leading to new record volume, creating good business opportunities.

We pointed out in the last *Investment Outlook* (March 2010) that good PE companies often have their best period after a recession. The same is also true this time around, and perhaps to a greater extent than usual considering the depth of the downturn. Listed companies are now carrying out major cost-cutting on a broad front, which will lead to good operational leverage once demand takes off, and higher margins will lead to large profit increases. This also applies to many of the PE companies' portfolio firms.

Widespread questions are being raised about company debts, and this "wall of debt" worries some observers. A record number of corporate bonds and credits will fall due during the next few years. Many PE companies have responded to this with loan extensions, corporate restructuring and other measures to reduce their sensitivity. In our judgement, the PE industry is easily capable of handling the situation.

Another storm cloud concerns regulation. Discussions are underway on both sides of the Atlantic about tightening the rules for the financial sector, including the PE industry. Not all proposals will be implemented, but the US government's intention to prohibit banks from owning PE investments may very well become a reality. Since banks own nearly 10 per cent of American PE investments, this would create supply pressure that would hurt prices in the secondary market, but it would also create good buying opportunities for those with capital to invest.

As we wrote in the last *Investment Outlook*, it is important to distinguish between good and bad PE. We are still focusing on investments that fulfil certain criteria that, in our judgement, reflect good PE in the prevailing market situation:

• Operational resources to pursue the reform process in target companies
• Target companies that have captured market share during the crisis
• Few problem companies in their portfolio
• "Dry powder" for new investments

"Long-term relationships with local lenders" were previously another important factor, but this now appears less important since the credit market has normalised.

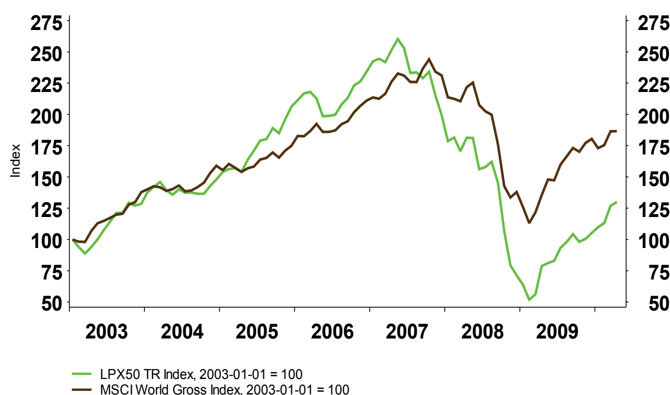
As for listed PE, we can state that its price performance has consistently been good. The LPE50 index has continued its recovery but has a long way to go before approaching its old peaks. Meanwhile these companies are continuing to trade at discounts in relation to their net asset value (NAV). The average discount is around 30 per cent. This is a substantially smaller discount than the low point a year ago, but still on a par with the lowest levels from the previous recession. The historical average is a discount of less than 10 per cent. It should also be noted here that the discounts – according to the companies – are calculated very conservatively. Among other things, there are often adjustments for any illiquidity.

Large discounts to NAV should shrink

One reason for the continued large discounts may be that investors mistrust net asset values. As transactions have now resumed, we see that companies tend to be sold at prices above the stated (conservative) NAVs. If this trend persists, NAVs should be accorded greater confidence, which should justify a smaller discount. Add to this that NAVs should be able to increase in today's more positive economic environment. Our conclusion is thus that there is room for sizeable price increases on listed PE, though with great volatility depending on the flow of news about possible regulation and other matters.

We also foresee continued very good business opportunities in the secondary market. As mentioned above, the supply is likely to grow as PE companies resume their investments and thus request more capital from investors who in some case are financially pressed. We are continuing our effort to identify attractive investment alternatives in this segment while retaining and, in a few cases, enlarging our listed private equity holdings.

SHARP PRICE UPTURNS FOR PE COMPANIES



Source: Reuters EcoWin

Listed PE company indices have climbed sharply since bottoming out last autumn, but during the crash PE companies fell more than the stock market as a whole. These companies have a long way to go before reaching their previous peaks.