Private Equity's New Landscape

The worst for private equity may be over. But as the market improves, the more pressing question is where does the industry go from here?

Clearly not all players will be starting from the same point of departure. While some general partners are in reasonable shape, secure in an unspoken alliance of inactivity with their investors, many others have been scrambling to refashion themselves as turnaround experts, swamped by broken portfolios and angry limited partners.

Two questions will define a firm's current state of health:

- Do you have more than 25 percent of your current equity at work in companies that need to renegotiate debt? A recent survey found that one out of every four funds will likely need to restructure more than a quarter of its portfolio in the next three years.
- Have you been caught with low reserves of "dry powder" when new supplies are nowhere to be found? About $500 billion in dry powder for buyouts is available globally, and double that amount when other types of private equity investments are included. But 22 percent of funds are at least 75 percent called on their most recent fund.

Answering yes to either one of these questions isn't fatal. But the combination can create trouble for PE business models that rely on raising one fund after another. Our research suggests that between 20 percent and 40 percent of all PE firms may be at risk.

Three scenarios

The outlook for individual firms depends on your point of departure and which part of the market you play in. For small-cap and growth funds, the past year may turn out to have been a speed bump. Deal volume is down, but given the lower debt requirements and manageable size, these deals will be the first to come back.

For mega-caps, on the other hand, this downturn has been a game-changer. Not long ago PE firms were competing to see who would be the first to ink a $50 billion deal. It's unlikely that we will see LBOs reach that scale for 10 years, perhaps longer.

Among mid- and large-cap firms, this period of crisis is likely to provoke a significant reshuffling of the deck. Rising to the top will depend on how quickly and sustainably you can develop three sets of capabilities:

1. **Educated risk-taking.** This seems obvious until you consider what often passed for reasonable risk analysis in recent years. Easy access to cheap debt and heavy leverage caused some PE firms to become undisciplined. With debt in short supply and priced at a premium, future returns will flow from a superior understanding of a particular business and its market. Proprietary insights also become an advantage in guiding how firms invest across the capital structure. Some firms, for instance, have profited handsomely from identifying which piece of the capital structure offers the best risk-adjusted returns.
2. ***Really* adding value after the deal.** Many firms talk about their "ops teams" and dedication to building companies. But most can't fully support these claims. Firms need to build—or know where to find—real capabilities in areas like working capital, procurement, pricing and sales force effectiveness. It's also critical to have a repeatable model—an engagement approach that works in good times and bad. Although the focus now is on fixing troubled companies, we all know that more value ultimately flows from improving good companies than saving bad ones.

3. **Retool executive engagement.** For years, the value proposition to management talent was simple: "We will make you very rich very soon, so make it happen. If you don't cut it, you're gone." But in the new landscape of PE, firms need to become more sophisticated and systematic about how they engage top talent. Over the past few years, corporations sought to learn the management lessons of the PE world. In this regard, the tables have turned.

   PE firms will likely have to establish effective "people plans" to help managers develop their skills and capabilities. The relationships will become more collaborative, more closely resembling the way a board and CEO work together. Increasingly, the message has to be: "We're building something together, beyond this engagement. Your success makes my success, and vice versa." A feeling of partnership leads to clear communication that allows problems to be aired early instead of covered up. PE investors need to be collaborators and advisers, not police.

Short- and medium-term outlook

For many firms, building and exercising these muscles will take time. Most will survive, but they will face a very difficult market in the short term. Leveraged deals, the industry's bread and butter, are unlikely to return soon in any numbers or size. Many have been surprised by the lack of deals emanating from corporations seeking urgent cash and banks looking for new owners for repossessed companies. The equity markets' appetite for rights issues coupled with banks' reluctance to take the keys explain much of the shortfall. The short supply of larger deals is driving some funds to drift away from their original strategy and focus instead on debt deals, distressed deals and private investment in public equity. Some are in intense discussions with their limited partners (LPs) about retiring funds and re-cutting incentives. The delays in fundraising are causing some firms to trim staff to match reduced-fee income.

The medium term outlook is much brighter. Credit *will* return eventually and there will likely be a period of auspicious deals as the market recovers. What will emerge is a more sophisticated and mature PE industry. Expect LPs to demand tighter fund documentation (protecting against "style drift," for instance) and even greater alignment on economics. This might mean significant reductions in transaction, arrangement and success fees in exchange for some improvements in carry economics. Most LPs will be much more sophisticated in the way they scrutinize firms' capabilities when it comes to the trinity of educated risk taking, adding value after the deal and retooling executive engagement. In response, PE firms are investing in their teams, strategies, networks and skills. The larger PE firms will likely offer more funds so investors can select among asset classes, sectors and regions.

With maturity, the industry's returns will likely narrow. Stiff competition and a reduction in froth will take out the high notes. But a more experienced industry will make fewer mistakes, weaker players will go away and the barriers to entry will grow. Unless there is a sudden rush of new money into private equity, a period of more consistent returns for more demanding investors beckons.

Key contacts in Bain's Global Private Equity practice are:

Global: Hugh MacArthur *(hugh.macarthur@bain.com)*
Europe: Graham Elton *(graham.elton@bain.com)*
Americas: Bill Halloran *(bill.halloran@bain.com)*
Asia-Pacific: Chul-Joon Park *(chul-joon.park@bain.com)*

For additional information, please visit **www.bain.com**