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MONEY MOUNTAIN

Private equity firms are sitting on $1 trillion of capital that they have not yet invested, says Alex Hawkes. The problem is finding something to buy

Private equity firms are swimming in cash, and don't know what to do with it. A casual observer of the financial world might think that was a good description of the state of the buyout industry in 2007, before credit markets came juddering to a halt. But the observation of private equity is also, surprisingly, a sentence that rings true today. Private equity firms worldwide are sitting on $1 trillion of capital yet to be invested, according to Bain & Co, the advisory firm.

The champagne corks are not popping, however. This is because some firms are struggling to raise new funds; others are struggling to find deals; many are finding they cannot realise profits on boom-era buyouts; and the elder statesmen of the industry are nearing retirement, creating complicated succession issues. There is still a lot of cash swilling around – but private equity is not what it used to be.

Swimming in cash

"Between 2006 and 2008, more than half the money ever invested in private equity was invested in those two years," says Stuart Howard, the COO of HarbourVest Global Private Equity, a $1.1bn listed fund that invests in the industry.

Much of that cash is still available to invest, as Bain & Co's most recent report into the private equity industry showed. The $1 trillion of capital held worldwide is "widely dispersed among PE firms of all sizes and types", it said.

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But having a lot of money to invest can, for private equity at least, be a problem. If it remains uninvested at the end of a fund's life, it is returned to investors – meaning the firms cannot earn management fees for future years on the cash, let alone have the chance to earn carried interest on the investments.

"Burning off the ageing dry powder will likely result in too much capital chasing too few deals throughout 2012," said Bain. It is a problem, it added, that is particularly acute in Western Europe.

"There's quite a lot of liquidity, because of a lack of assets to buy and sell. For various reasons there are not enough good assets in the marketplace," says Marissa Thomas, private equity leader at PricewaterhouseCoopers (PwC) UK.

One reason for that is the extreme volatility seen recently in equity markets, as stocks oscillate wildly, according to the latest news from the eurozone. It has created uncertainty around pricing of company assets – meaning the M&A market is quiet.

Till debt do us part

The popular perception of private equity is that it is an industry funded on debt, and which grew fat on the credit boom that ended in 2007. It should, by rights, be suffering now.

Debt is still a big issue for private equity firms – and one that is seeing them fall behind big listed companies, which now hold the upper hand.

David Reitman, a corporate finance partner and debt expert at KPMG, points to Heineken's most recent bond issue.

A BBB+ rated company, the brewer borrowed for 13 years in August at a rate of 2.875%. For private equity, the cost of senior debt is more like 6-8%, Reitman says.

Given the increasing cost and lack of liquidity, private equity firms have more recently taken on less debt when buying companies. There are a number of ways of tracking that trend. Reitman points to figures showing that the average total leverage on a private equity deal in the first quarter of 2007 was 6.5 times the company's EBITDA; it is now a multiple of 4.3.

Jim Keeling, a corporate financier at advisory firm Corbett Keeling, looks at it another way: "In 2007, about 10% of deals were done without any debt. A couple of years later, it was about 50%."

Darren Redmayne, UK CEO of Lincoln International, which advises on buyouts, says: "It's still a major part of the PE model to leverage. They tend to be more cautious about it now. Corporates are much better placed to buy assets. They can probably borrow at least as well and they have the equity within the acquirer. The equity is more committed, it's more deliverable."

That is a big change; he adds: "Historically, PE groups have been able to pay more and be more deliverable."

Legacy of the crisis

Guy Hands, the chief executive of private equity giant Terra Firma, made a striking observation at the SuperInvestor conference in Paris last November: that private equity firms might need to inject €450bn worth of new capital into their portfolio companies.

Between 2013 and 2015, he said €3 trillion worth of deals would need to be refinanced, and with banks cutting back on their loan-to-value ratios, private equity would have to find cash equivalent to 15% of those companies' values.

The refinancing of debt-laden boom-time purchases is a story that is taking its time to materialise, however.

"Everyone expected restructuring activity. It's been kicked down the road," says PwC's Thomas.

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"We have seen the banks 'amend and extend'. Ultimately, it will happen. A lot of people will be looking to refinance opportunistically," adds KPMG's Reitman. He believes many will be looking for short-term bursts of optimism in the debt markets to restructure their debt burdens at low rates.

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"PE exit activity began 2012 just as it ended 2011 – dead in the water," says Bain & Co. It is the flip side of having nothing to buy. Nobody is able to sell, either.

"Conditions conducive for general partners to sell portfolio assets – clarity about the direction of the economy and a reasonably close match in valuation expectations between buyers and sellers – have been elusive since mid 2011, and they look to remain so. Until uncertainty lifts, it is difficult to see how exit opportunities will improve," Bain's report said.

Blow-ups

As well as debt issues overhanging current investments, there are some private equity houses that are stuttering and failing to raise new cash.

Duke Street Capital, which owns high street noodle chain Wagamama, gave up attempts to raise an £850m fund in February, saying it would instead raise cash on a deal-by-deal basis.

Listed private equity fund Candover called it a day in August 2010, saying it would unwind its assets, after investments such as Italian yacht company Ferretti and gambling company Gala Coral turned sour.

AAC Capital, the former ABN Amro buyout business, failed in its attempts to raise a new fund in April.

In each case there are complicated reasons for the demise. The general story is that while the M&A market has been so dormant, investors have not seen their cash returned to them in many cases and don't have as much cash to pledge. And besides, without realisations, it is difficult to assess who made the right calls and who didn't during the boom – provoking greater scepticism among investors.

According to Bain, three-quarters of buyout funds that aimed to raise more money in 2012 wanted to raise the same or more than last time out. Many of them were likely to be disappointed, it said, observing that funds wanted to raise 2.8 times as much capital globally in 2012 as they were able to raise in all of 2011.

Where will they find all that capital? Certainly not with their traditional investors – pension funds and other institutions. Many have to reduce their exposure to private equity due to Basel III rules, which means they must put more capital aside if they invest in private equity.

"Most limited partners have downscaled their allocation to PE. The 07/08 funds have not produced the return, and there's a reluctance to put the same amount of money to work," says Thomas.

The disappearance of big names from the industry could be a slow process, as fundraisings fail to materialise, and portfolios are wound down. It is also very secretive.

"Private equity is, by definition, private, so the true extent of the challenges aren't known in the market," says Redmayne.

Opportunities and threats

The picture is not the same everywhere in Europe. While Spain, Italy and Greece may be in the doldrums, there are some chinks of light.

"Scandinavia is busy. They are outside the euro, the banks are well capitalised and outside of the banking crisis. They are seeing sustained and positive activity. The only problem is it's an export market – and they are exporting to markets that have challenges," says Redmayne.

Thomas separately points to Advent International, Mid Europa Partners and BC Partners as three firms that have carved out successful niches investing in Eastern Europe. "If you've got a differentiated offering, that's helpful at the moment," she says.

Howard of HarbourVest is pinning his hopes on the idea that private equity has become a much more mature asset class – and that his listed fund of funds will attract a broader audience of investors hoping for exposure to private equity.

For those who work in private equity funds, perhaps the greatest concern is that private equity is no longer a get-rich-quick scheme.

PERSONNEL PROBLEMS

People are a profound challenge for the private equity industry, as talented private equity executives move around like never before. Redmayne says personnel retention is a key test for firms: "Before the crash, if you were in a PE fund, your economics were aligned to that fund. If you can see that the carried interest has gone, there's no reason to stay."

And a more profound shift is taking place, albeit quietly – a changing of the guard as the first generation of private equity investors looks to hang up its boots. According to Redmayne, they are working out how to hand on the franchise, while raising new cash on the back of their track records.

Thomas says that for all the problems with private equity, its executives retain a key advantage over other people in the M&A marketplace – their dynamism: "They are very agile and very focused. They can commit to a timetable others can never commit to."

With cash to spend, and a new generation itching to spend it, the private equity doldrums might not last too long after all.

Howard, whose funds invest in 300 different private equity firms, says the payment model has changed. Private equity used to charge a 2% management fee, and where a fund realised anything over 8%, the fund's managers would take 20% of the 'carry'. Those figures have come down, he says – although given the secrecy, it is unclear how far.

In any event, for many boom-time investments there is no 'carry' to take.

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