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The future of private equity

These funds face a credit-constrained world; they must adapt to thrive.

Conor Kehoe and Robert N. Palter

Is there life after leverage for private equity? The global financial system is struggling to work its way out of disaster: banks are flat on their backs, equity markets have plummeted, and a business culture built on leveraged portfolios has come unhinged. The future of private equity is one of the more intriguing questions for corporate finance and corporate governance alike.

It may seem hard to be sanguine about the sector’s long-term prospects. With returns under pressure, private-equity firms will struggle to perform.¹ The megabuyouts (deals valued at more than €5 billion) that absorbed so much of the sector’s capital since 2004 are nowhere to be found. Some limited partners—in particular, sovereign-wealth funds—have shown a willingness to bypass private-equity firms and strike out on their own. With an estimated $470 billion in committed but unused funds, the sector faces an enormous challenge just finding ways to invest. Finally, its portfolio companies, with their high debt levels, may become financially distressed and default in the event of only small downturns in sales and EBITDA.² Recent bankruptcies of several private equity–backed companies hint at how dark the future may be.

Yet the prognosis isn’t entirely bleak. In our experience, the sector’s strengths have come not from its use of leverage but from its ability to marshal resources, both human and financial; its strong incentives to adapt quickly; and its active ownership. Opportunities do exist: megadeals may have vanished, but not medium-sized or all-equity deals. Moreover, private-equity firms are well poised to stand in as a new class of shareholder in the overturned public-equity market, in developing economies, and in financial institutions. Despite the current difficulties, it bears remembering that the best private-equity firms have persistently outperformed both their private-equity counterparts and the public-equity markets, in good times and bad, over the past two decades. The winners will be firms with the wits to adapt to a much harsher environment.

¹ Even the venerable 2 percent management fee and 20 percent carry structure may be vulnerable as limited partners respond to the current crisis and the weakening performance of buyout funds.
² Earnings before interest, taxes, depreciation, and amortization.
Managing the downturn

Right now, the first priority for the vast majority of private-equity firms is mitigating the recession’s impact on portfolio companies and, to some extent, on cash-strapped limited partners.

Yet contrary to common perceptions, the challenges portfolio companies face do not result from levered risky investments. The average private equity–owned company, despite its higher initial leverage, is only slightly riskier than an average public-market company. Indeed, although the typical leveraged buyout starts with more than twice the leverage of its public-market counterpart, its leverage is often lower on exit. In addition, research shows that private-equity firms tend to buy steady companies whose volatility, before the extra leverage, is about two-thirds that of companies listed on public markets. Portfolios tend to be concentrated in companies and sectors less susceptible to the effects of booms and busts—a critical condition for supporting the higher initial leverage the private-equity model has typically deployed. Not surprisingly, private-equity portfolios, though spread across most industries, are underrepresented in the battered construction, automobile, and financial-services sectors. We expect the revenues and before-interest earnings of private equity–owned companies will fall less than those of companies listed in public markets.

Moreover, private-equity firms also enter this downturn with much stronger operational capabilities—either in house or through external support networks—than they had in previous downturns. In the short term, all the committed but unused capital could be turned to advantage if it were deployed in overstretched portfolio companies. And the lessons of the 1990 downturn, when the debt levels of private equity–owned companies were much higher, suggest that even if such companies go into bankruptcy, they are more valuable than they would have been without private-equity ownership, despite the costly process of managing the reorganization. That’s good news for employees and customers, if not equity investors.

There will of course be failures, even in the short term, and each private-equity firm should move aggressively to reduce the threats in its portfolio’s cash, cost, and risk position and to mitigate their effects. What’s more, since exits are now very difficult, it will be necessary to learn how to manage portfolio companies beyond the normal three- to four-year cycle, without letting returns slip. Some private-equity firms are already addressing this problem by simulating an internal sale when the initial value creation plan runs its three-year course—in other words, forcing themselves to take an outsider’s perspective to identify missed opportunities. These firms review such companies and their industries and appoint new internal teams, if necessary, to develop another value creation plan, to change management, or to conduct a due-diligence process as if the firm were buying the business anew.

Finally, many private-equity firms that expanded their staffs and opened new offices during the recent investment surge must now make do with less. Even the top performers can expect smaller funds and lower fee income in the next few years.

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Managing investors
Private-equity firms will need to manage their relationships with investors carefully. Limited partners are not protected from the general downturn. Some are having difficulty meeting their commitments to provide funds—in particular, because reduction in the value of quoted equities has mechanically increased the percentage of assets allocated to private equity.\(^5\) Further, the difficulty of exiting from portfolio companies means that money from private-equity funds is flowing back much more slowly than might have been expected. Some supposedly liquid assets, which limited partners could otherwise have sold to finance private-equity cash calls, aren’t nearly as liquid as had been assumed.

Except in extreme circumstances, limited partners probably won’t default—they’d risk losing the cash they have already subscribed and access to top funds—but they may pressure private-equity firms to reduce fees, commitments, or both if investment opportunities don’t open up soon. In the near future, limited partners may also demand improved terms before subscribing to new funds and invest lower amounts in them. Private-equity firms should act strategically in these situations by giving some limited partners more flexible terms if they experience short-term difficulties. This approach could play an important role in maintaining relationships with attractive long-term funding sources.

A relatively new class of private-equity investor—sovereign-wealth funds—needs particularly careful nurturing. These long-term investors constitute a very large group in the aggregate, with $3 trillion in total assets in 2007 and a projected $8 trillion in the next decade. By the end of 2007, they had committed about $300 billion to the private-equity sector, but they can bypass it entirely if they wish by investing their cash directly. Their recent direct investments already include the stakes that the government of Singapore and the Kuwaiti Investment Authority took in Western banks last year, as well as the holdings of direct-investment arms such as Mubadala Development (Abu Dhabi) and Temasek Holdings (Singapore). It can be tricky for sovereign-wealth funds to be assertive and active owners, though, especially in Western companies. Investing through private-equity firms raises fewer political hackles, but the firms will need to sharpen their value proposition.

By and large, the sector is well prepared for these challenges. Active ownership is its biggest competitive advantage over companies in the quoted market: the best private-equity firms are more effective because of their stronger strategic leadership and performance oversight, as well as their ability to manage key stakeholders.\(^6\) Firms must continue to hone these skills and to ensure that they are applied consistently. Even the better firms have a great deal of opportunity for improvement—particularly in attracting partners with the right operating skills, getting a better balance between financiers and active owners, adding people who have experience in downturns, and reviewing the current portfolio with the rigor traditionally devoted to new investments.

Finding new ways to invest
In the long term, the math of deploying the industry’s $470 billion in committed but uninvested capital looks challenging. Forty percent (about $240 billion) of the equity capital that private-equity firms invested from 2004 to 2007 financed 55 megadeals (2 percent of all private-equity deals). It could take a long time for megadeals to reemerge if recently completed ones perform less well than quoted companies

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\(^{6}\) Private equity—owned companies aren’t always marked to market, yet the investors’ public securities are—so the value of the latter appears to have declined much more.
do. And even if the core midmarket leveraged buyout comes back quickly, it probably won’t absorb all the available capital, so the sector must look for new investment opportunities. Given its current market share—the value of the capital that private equity controls equals only some 2 to 3 percent of the total value of all the equity quoted on public markets—more opportunities for active owners exist, though few are proven.

Private investment in public equity
One way for private-equity firms to use their ownership expertise would be to channel some of the capital under their control into public companies through private investment in public equity (PIPE) and to assert themselves, even without complete control, on the boards of those companies. The benefit to a public company’s executives—besides quick access to capital—would be the commitment of a shareholder that will be stable in the medium term and perhaps provide them with private equity–style incentives to ensure that the company acts in the interest of shareholders. Private-equity firms will need to learn how to operate in public companies, however. Private-equity board members can help a public company focus on shareholder value, as well as offer their own time and the resources of their firms and networks. But they have much to learn from their public-market colleagues about communicating with a dispersed body of stakeholders and compliance with public-market regulation.

Developing markets
Companies in developing markets enjoy favorable demographics and are opening up to the global economy. Nonetheless, immature regulatory and legal systems, along with a lack of transparency, can bedevil outside investors who lack connections to the companies in which they invest. Although those companies may have local sources of new money, they often lack the value-adding capital that experienced private-equity firms can offer. In particular, family-controlled companies that aim to excel internationally see them as a way to gain expertise previously available only from multinationals. Private-equity firms can deploy their managerial and sectoral know-how to help such companies, family owned or otherwise, and to provide close local supervision on behalf of the firms’ international investors. These companies are a very important long-term outlet for private-equity firms, though from 2003 to 2007 their investments outside Europe and North America accounted for only around 5 percent of their $630 billion of invested equity.

Financial institutions
In the past, private-equity firms seldom invested in financial institutions, like banks and insurance companies, which are already leveraged to very high levels set by regulators, as the current banking crisis has clearly demonstrated. Yet today such institutions provide a fascinating opportunity: they may be cheap, their productivity varies widely, and recent events show that they clearly need more intense governance and will face demands that they obtain it. The board of an average bank, for example, could add considerable value by resolving to use a private-equity–like approach to improve the bank’s operational and risk-management practices. Measuring the value of so-called toxic assets presents real

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7 After the late-1980s collapse of the junk-bond market, the $25 billion (enterprise value) RJR Nabisco deal of 1998, at more than 90 percent leverage, wasn’t topped until 2006.
8 The purchase of stock, at a discount to the current market value per share, by a private-investment firm, mutual fund, or other qualified investor for the purpose of raising capital for the issuing company. The discount is needed when companies seek to raise significant capital or when there is an illiquidity provision in the agreement.
difficulties to a private-equity transaction, however, and these risks may be too great unless the authorities hive off such assets to a “bad” bank. Private-equity firms might then be tempted to infuse the “good” institutions with much-needed private capital—and $470 billion of it gives the authorities a strong incentive to explore this route.

The alternative

If the private-equity sector can’t identify new channels for investment, it may have to contract. In any event, it will probably concentrate. The top ten firms controlled 30 percent of the sector’s capital in 2008, just as they did in 1998. Since then, the idea that private equity has persistent outperformers and underperformers has been analytically substantiated and taken root. We therefore expect that the more discriminating limited partners will concentrate European and US investments in fewer private-equity firms and that many firms will disappear when they can’t raise their next round of funds.9

Private equity’s core value proposition—superior representation to maximize returns for the long-term investor—remains sound. But private-equity firms that hope to survive must adapt to a new world.

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9 Allocations to newcomers in emerging markets may offset this concentration in the developed world.