# ESSAY: IS PRIVATE EQUITY AT A TURNING POINT?

ROY C. SMITH*

In the spring of 2009, I was asked by the *NYU Journal of Law & Business* to take a look at, and report on, the state of the Private Equity business in order to determine whether the industry had reached a turning point. My conclusion was that I hoped so, as it was hard to see how it could get any worse.

Indeed, it now seems a very long time since Steven Schwartzman's much-reported, $3 million birthday party at the height of the investment cycle in February 2007 that was followed by the mould-breaking initial public offering ("IPO") of the firm Schwartzman headed, The Blackstone Group, four months later. By then, the Private Equity industry had experienced an extraordinary inflow of about $1 trillion since 2002 as pension funds, endowments, and wealthy families sought to increase their asset allocations into Private Equity and the market returns since then had been very generous.

All the new money helped boost activity in the leveraged buyout market. During the first half of 2007, when the market was at its peak, nearly one out of four U.S. acquisitions was in the form of a leveraged buyout ("LBO"), including a $45 billion transaction for the Texas electric public utility, TXU, arranged by Kohlberg Kravis Roberts and Texas Pacific Group ("TPG"), and a later record-smashing $52 billion deal for the Canadian telephone giant, BCE, led by Providence Equity Partners. The business was equally robust in Europe. Private Equity firms paid investment banking fees of nearly $50 billion from 2005 through 2007.

The much awaited Blackstone IPO was priced at 10 times book value, valuing Blackstone at $38 billion, and the issue was generally understood to be a great success. A few days later, however, two Bear Stearns hedge funds that were invested in sub-prime mortgages failed, triggering the 2007-2008 mortgage securities crisis that spread to become the worst global financial calamity in seventy-five years.

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* Kenneth Langone Professor of Entrepreneurship and Finance, Stern School of Business, New York University



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The crisis quickly enveloped Private Equity. The supply of leverage for leveraged buyouts, which had been more abundant than ever until June of 2007, abruptly came to an end. The prices of existing leveraged loans began to sink, and banks sought to renegotiate the terms of deals that had been agreed but not yet closed. A large overhang of these large, minimally syndicated deals developed by the Fall; they were difficult or impossible to distribute, and their declining prices forced banks to write the loans down.

In November 2007, Financial Accounting Standard ("FAS") 157, which provided new rules for Fair Value Accounting, came into effect, requiring Private Equity fund managers to value their investments at market prices, even in seriously distressed markets. This rule change required a great many mark-downs during 2008 that might not otherwise have occurred. Blackstone reported a loss of more than $1 billion for 2008, after marking positions down by 30 to 50 percent.

Starved for credit, and facing harsh conditions as the economy slid into recession, many promising LBO deals from the past slid into trouble. Even so, distress in one sector often sparks interest among some of the bolder, more opportunistic Private Equity investors. This time the counter-cyclical approach would provide no relief to some who tried it on a large scale: Cerberus invested $12 billion in controlling positions in General Motors Acceptance Corporation and Chrysler, only to gain ring-side seats for the slow death of both companies. TPG stepped up to lead a $7 billion investment in Washington Mutual, only to lose it all seven months later.

Some sponsors of LBOs that had not closed by the end of 2007 tried to abandon the deals, only to face tough resistance from the sellers—Hexion, a company owned by Apollo Management, was forced to pay $1 billion to settle such a dispute with Huntsman Chemical.

Further, fund managers had to struggle with investors seeking to rebalance their portfolios, or simply trying to get out of their positions. Many of these investors sold their positions in the secondary market, or tried get out of paying future capital calls, or to have management fees be lowered. Write-downs of fund portfolios dropped returns well below high-water marks that would have to be exceeded before performance fees could be paid to managers, some of whom began to

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look around for something else to do. The stock prices of all of the publicly traded Private Equity fund managers collapsed. Blackstone's stock, for example, fell from a princely high of $38 per share just after its IPO to $3.55 in February 2009, a decline of 91 percent in just over eighteen months.

And it may yet get worse. Many fully leveraged LBOs have fallen into bankruptcy, transferring whatever wealth was left in the enterprise to creditors. Others surely will follow as the economy sinks further and bankruptcies in general increase.

Private equity funds sought to raise nearly $900 billion in the first quarter of 2009 but were able to close on only about $50 billion. These results suggest that institutional investors may be retreating from the Private Equity industry as fast as they run to it after 2002. Without the ability to raise new funds, some managers will be exiting the business over the next few years.

The difficulties in the Private Equity business, however, did not deter Congress and the new presidential administration from continuing to explore the idea of taxing fund managers' carried interests at regular income tax rates, instead of capital gains, which had been the practice since the industry began.

Notwithstanding all these gloomy factors and the bleak outlook they impose, the industry may be moving toward a position from which to begin an impressive recovery. The up-side potential for the Private Equity business may never have been greater.

This does not mean, of course, that all the existing players will survive and return to glory. Some will, but certainly not all—market cycles take their toll and will on this occasion as well. Nevertheless, there is room for hope.

The industry as a whole still has several hundred billion of uncalled capital available from existing funds. Some of this may be cancelled but most will be called and paid in, and fund managers will use the money to shore up existing companies that are squeezed for credit and to make new investments with less leverage at low prices reflecting today's economic reality. Giving the economic cycle five or six years to recover could result in some fine results for new investments and salvage returns of capital from surviving older deals. And, as market conditions recover, which they will do in time, FAS 157 will be-

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come the friend of fund managers who were forced to take heavy write-offs during the darkest days—these positions can be reversed and improvements in value recorded.

The backlog of restructuring deals needing to be done is increasing—many large, conglomerated companies in economic trouble need to be able to sell subsidiaries and divisions to recover capital, reduce leverage, and to reposition their businesses into more promising strategies. Think of AIG, Citi-Holdings, HSBC, and Barclays Bank all trying to sell assets. Or, of GE, Time Warner, and American Express that ought to consider selling some. And the auto, energy, and telecom industries, which are just beginning major restructurings. There are industrial and financial groups all over the world needing to be taken apart and rebuilt, and the Private Equity industry has 30 years of knowhow, resources, and imagination to make these sorts of transactions work and add value.

There are also roads and bridges, and other public infrastructure projects—now in serious demand to reduce the pressure on state budgets—such as the sale-leaseback of the New Jersey and Pennsylvania turnpikes, which were recently rejected by their legislatures. The next time around, however, the projects may be approved as the last best way to recover the use of capital for states that are rapidly running out of it.

The Private Equity industry that will rise up to meet these opportunities, however, will be different in some respects from the present one.

Investment banks have played a large role in the industry to date. But the investment banks have recently disappeared, merged or evolved into Bank Holding Companies, in which they may not be able to retain some of their riskier activities in the future. Top Private Equity talent may not be able to function well inside a more restricted and heavily regulated Bank Holding Company. This talent may migrate (as it has been doing for some years) to existing or new Private Equity vehicles. This will be true also for talent of the older firms that are winding down, or forced to face several years of working out of legacy positions. These and other changes are bound to occur in the industry as it adjusts to current conditions and future opportunities. It is all yet another example of "creative destruction" in a market economy, something we Americans are used to.

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