

Investors drive change in private equity

September 14, 2009

After a major shakeout in the private-equity industry in 2008, investors continue to force the industry through a necessary evolution.

Until now, the LBO (leveraged buyout) private-equity industry, buoyed by commitments from investors, also known as limited partners, has not witnessed a serious weeding out of weaker players.

In [their previous White Paper](#), authors Heino Meerkatt (Boston Consulting Group) and [Heinrich Liechtenstein](#) (IESE) predicted that the financial and economic crisis would induce such an industry shakeout, with 20 to 40 percent of the 100 largest LBO private-equity firms going out of business.

Now, they say, there is more capital — and more change — to come.

In their White Paper, "[Driving the Shakeout in Private Equity: The Role of Investors in the Industry's Renaissance](#)," they highlight a shift in the balance of power toward investors. Investors will continue to drive further changes, determining who wins and who loses. Those with funding problems who are anchor investors are likely to drag their firms down.

The authors based their findings on a proprietary database of over 3,000 commitments by investors to private-equity and from commercial databases. They also had in-depth interviews with more than 30 investors and private equity firms in the United States and Europe. Their findings are largely positive for the industry as a whole.

Enough dry powder

The available dry powder, or undrawn capital commitments, is bigger than ever today, standing at around \$550 billion compared with \$460 billion at the end of 2006.

The authors estimate that, on average, investors will reduce their capital commitments by 5 to 15 percent. This still leaves private-equity firms with around \$500 billion of dry powder.

The question, of course, is how much of this investors will actually deliver when firms come calling. Based on their probability analysis, the authors' answer is a significant amount.

Default is a dirty word

First, there will be few defaults. Any cash-constrained investor would rather sell his commitments in the secondary market, even at a loss, than suffer long-term damage to his reputation by defaulting.

In fact, many distressed investors are likely to sell their commitments on the secondary market, a trend that started in 2006. This will have no impact on the overall amount of dry powder available to private-equity firms. These sales also present attractive buying opportunities for those with liquidity.

Finally, as already seen in Europe and the United States, some investors will scale down their commitments. Typically, this will involve the anchor investor or a group of influential investors. The likelihood of downward renegotiation is greater among private-equity firms targeting megadeals. These firms may also try to renegotiate their terms with their investors to enable them to redirect some of the capital to smaller deals or other asset classes.

Delivery depends on investor

Although there may be enough liquidity overall, investors' ability to meet their commitments varies across the board. The authors categorized investors by importance to the industry, present and future, according to their relative share of outstanding dry powder.

Public pension funds — the biggest players in private equity by a substantial margin, with commitments of about \$150 billion, some 30 percent of the total — are likely to keep this position. In fact, there is evidence that public pension funds are raising their targets. Their influence will, therefore, increase in the private-equity universe.

Insurance companies will maintain their share and importance. Sovereign wealth funds, in particular, are likely to exploit the cheaper opportunities to increase their exposure to the private-equity market.

Private pension funds of large, healthy corporations — currently accounting for the third largest share of dry powder — are expected to remain steady, although the picture is mixed as less stable, smaller companies may run into difficulties.

Financial institutions are the most likely group of investors to reduce their commitments. Along with family offices and endowments, they will become less relevant to the private-equity industry.

A firm's relative investor exposure, therefore, becomes a key factor for survival. Firms with a favorable mix of investors will survive. Those that have a large exposure to investors who reduce commitments face capital cuts that threaten their long-term viability.

However, even if much of the firm's commitments come from distressed investors, the firm could still be secure if the anchor investor is financially stable. A detailed analysis of investors could, therefore, flag individual losers.

Empowered investors call for change

The balance of power has clearly shifted toward investors. They, in turn, will accelerate major changes in the workings of the private-equity industry.

Topics that have been under discussion for years will assume a new urgency. Investors will look more closely at each other's financial positions. Private-equity firms will also come under pressure to make their valuations more transparent. Fee structures are likely to be revised.

Significantly, private-equity firms may use some of their dry powder to bail out their current portfolio companies rather than engage in new buyouts. To do this, they may require their investors' consent.

A better future for all

The net result is more investor involvement in the private-equity industry. Before committing capital, investors will look more closely at the operational side of a firm, rather than just relying on quantitative analyses of past sources of value creation such as leverage and multiple expansion.

Private-equity firms will have to work harder for their money. All this is good news for the maturity of the industry. It is in the interests of all the players that the restructuring takes place as swiftly as possible.

www.iese.edu/insight