Private-equity shakeout: Steps to confront the crisis

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With many private-equity firms not expecting to raise the next fund, between 20 and 40 percent of LBO firms could go under within the next three years as a result of the economic crisis.

Over the past five years, private-equity firms have sustained above-average returns and shown exponential growth due to a favorable economic climate and four major drivers: cheap debt, rising profitability, escalating asset prices and the allocation of significant assets from institutional investors to private-equity funds.

Not anymore. The recent financial and economic meltdown has brought all that to a screeching halt.

In a new paper published jointly by IESE and The Boston Consulting Group (BCG), IESE Prof. Heinrich Liechtenstein and Munich-based senior partner and private-equity expert Heino Meerkatt use publicly available data from private-equity firms, portfolio companies, banks and credit default swap rates to analyze the cause of the recent crisis and to predict how the shakeout will affect the players in the industry.

The perfect storm

The perfect storm that the private-equity market finds itself in has had a trickle-down effect, leading to the probable default of many portfolio companies. The potential book loss from these defaults is estimated at $300 billion.

The debt markets have come to a virtual standstill, with volumes 75 percent lower for the third quarter of 2008 than for the same period of 2007. Company earnings have also dropped, with most industries registering negative EBITDA growth. The 45 percent drop in stock prices in 2008 has also dramatically reduced returns by multiples.

Private-equity firms have experienced the biggest impact. The authors estimate that between 20 and 40 percent of LBO private-equity firms will go under within the next three years. At least 30 percent should survive, they say.

In terms of portfolio companies, the authors do not foresee an economic shockwave, although they do predict a large number of defaults, which may lead to significant restructuring in portfolio companies, massive cost-cutting and painful layoffs.

Yet the authors remain confident that these companies, even though they are defaulting, have the same chances of survival as companies not owned by private-equity firms.

The authors conclude by offering three steps that private-equity firms should take to confront the current crisis:

- Prepare their portfolio companies for a long and deep recession, focusing on operational improvements.
- Look for opportunities to take stakes in the troubled portfolio companies of other firms.
- Offer equity in a wider corporate arena.

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