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Private Equity— After the Downturn

THE WORLDWIDE ECONOMIC DOWNTURN HAS PUT UNPARALLELED pressure on private equity (PE) firms, and the challenging times are likely to last for the next few years. Deals that would have settled for about 15% in equity just a couple of years ago now demand 35% to 40%, and as much as 75% for some smaller buyouts. Perhaps most notable is the tidal wave of refinancings coming due in 2012, which could test the survival of many portfolio companies—and PE firms, too. This report outlines the key developments affecting PE and offers a forward-looking view on possible scenarios in the sector in the years immediately ahead, including in India and China.

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The Coming 'Wall' of Refinancings: A Trial for Private Equity Firms—and Their Portfolio Companies

Private equity faced a difficult environment in the wake of the recession, as credit markets worked to absorb maturing debt from large leveraged buyouts. Financial sponsors are scrambling to prepare for the rash of refinancings set to come to market in 2012, according to panelists at the 2009 Wharton Private Equity & Venture Capital Conference. Many firms have been focusing on portfolio company operations, exploring new positions in the capital structure and considering strategic, synergistic transactions.

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'True Turnaround Specialists' Are Poised to Survive in Today's Challenging Private Equity Market

As the economic downturn forced an upswing in bankruptcies during 2009, private equity began to turn away from traditional leveraged deals and toward investment in distressed companies, according to speakers at the 2009 Wharton Private Equity & Venture Capital Conference. Expect a tidal wave of private equity deals made in 2006 and 2007 to go bad in the next few years, say specialists in distressed businesses. Also look for a sharp rise in restructurings outside of bankruptcy court.

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India and China Offer Attractive Private Equity Opportunities, but Without Majority Control

China and India continue to offer highly attractive opportunities for prudent private equity investors thanks to their strong economic fundamentals, which have helped them to weather the worldwide downturn better than many Western industrialized countries. But successful private equity investments in these large, emerging economies require careful planning and a regional presence in order to identify lucrative opportunities, and to better understand potential competitive threats. Learn more about PE investment in these countries in this interview with Dalip Pathak of Warburg Pincus and Alastair Gibbons of Bridgepoint Capital.

The Coming 'Wall' of Refinancings:

A Trial for Private Equity Firms—and Their Portfolio Companies

Private equity faces significant challenges as credit markets try to absorb maturing debt from large leveraged buyouts. Panelists at the 2009 Wharton Private Equity & Venture Capital Conference said financial sponsors are scrambling to prepare for the refinancings that will start coming onto markets in 2012.

According to panelists who took part in a discussion titled, "Leveraged Buyouts: Strategies in Times of Turmoil," firms are focusing hard on portfolio company operations, exploring new positions in the capital structure and considering strategic, synergistic transactions.

Jack Daly, managing director of Goldman Sachs' principal investment area, put the crisis in historical perspective, noting that 2007 and 2008 represent sharply different markets. In 2007, the market was robust, with easy access to credit, liberal loan covenants, and the possibility of a $100 billion buyout. By the end of 2008, everything was different. "Today, we have no credit market," he said. "Life has changed." Buyout multiples have dropped, and deal volume is down 75% since 2007.

He pointed to an analysis by Ned Davis Research of the ratio of credit to GDP over the last 100 years. Over most of that time, the figure ranged from 140% to 160%, but it spiked to 265% before the Great Depression. It rose to the highest levels ever, more than 300%, approaching the current downturn. Returning to more natural levels will require high savings rates, inflation, or a massive markdown of bad debt, he said.

In the boom years from 2005 to 2007, private equity deals were completed with as little as 15% equity, leaving leveraged portions at a higher rate than in the 1980s and 1990s. Since the economic meltdown that began in late 2007, 35% to 40% equity has been required. For smaller buyouts, Daly stated, the equity requirement is 50% to 75%.

According to Garrett Moran, senior managing director at the Blackstone Group, the economy is experiencing "the mother of all recessions," and the stock market (early in 2009) is effectively saying that the financial sector is bankrupt. He noted that during the last big wave of private equity financing, hedge funds were flush and found it easy to leverage syndicated products. In 2006, financial sector market capitalizations had doubled from just a few years earlier. Looking forward three or four years, he said, the industry will have decreased dramatically, with hedge funds no longer leveraging deals with 90% debt levels. "All these companies will have to refinance into a much smaller market. So we're going to see a world of distress."

Questions About Viability

Moran referred to a "wall" of private equity bank financing that will mature in

2012 and 2013. Because of this, private equity firms must increase cash margins. Blackstone has been meeting with its portfolio company management teams and scrutinizing projections for 2009 and 2010. In order to conserve cash, some managers are closing plants and trying to sell assets, he said, but asset sales are difficult in the current environment. Blackstone is questioning whether business models and assumptions are viable even after significant cost cuts. Moran added that companies are "skinnying down," taking a strategic look at their models. If a portfolio company's model requires cash early on to meet the promise of opportunity later, "you have to get rid of it."

Operational team meetings are being set to devise 100-day plans focusing on issues such as supply-chain management and sales programs. "Basically, management teams are being told to 'bar the door. Take more severe actions,'" said Moran. One course of action, for example, is to ramp up outsourcing.

Private equity firms, Moran predicted, will experience a "slow-motion" period over the next three to four years in which firms can restructure, buy back portfolio company debt, or take other operational steps "to be all set to have handsome returns when the refinancing hits." Some companies are approaching private equity firms about partnerships, he added, noting that Blackstone created a partnership with Bain Capital and NBC Universal to take control of the Weather Channel, with NBC as the operating partner. "When the dust settles, there will be more private equity going into corporate partnerships than corporate money going into private equity firms."

Peter J. Clare, managing director at the Carlyle Group, predicted that credit markets would remain expensive for close to two years, suggesting it would take at least that long for the banking system to get its bad assets off the books and recapitalize.

Relationships Mean Less

Buddy Gumina, a partner in Apax Partners, said the changing credit picture would have a major impact on private equity portfolio companies. In the last few years, as the economy boomed, banks were eager to lend. If a borrower had a problem, the bank would fall back on relationships and cooperate with management as it worked through the difficulty. Now, he said, relationships no longer rule. "In today's market, the reasonableness is often gone and [lenders] are instructed to push as hard as possible to extract as much value as they can."

Private equity firms are on the defensive. Gumina said that while the firm once spent much of its time on deal generation, the emphasis now is on operations. "We have clearly shifted in a very, very organized way within the firm. We are looking at each portfolio company and questioning the business model, the cash flows, and the ability to survive."

Gumina said Apax is preparing more than ever to take advantage of potential consolidation or investments from strategic buyers or investors, especially because it expects economic conditions to remain murky for the next 18 months. "We would rather do something today and shore up the capital structure than wait until later when there are fewer options. From a limited partner standpoint, they are looking for us to be thoughtful and creative."

Returns are going to matter a great deal in the near future, he added, because when it is time to raise money again, limited partners will want to see how well private equity firms managed their portfolio companies during the recession. "One solution could be capital injections and also being very operationally involved in the businesses."

Daly said he, too, is concerned about the large amount of private equity debt due to mature. "It's unclear to me how we're going to end up dealing with that in 2012, 2013 and 2014. It sounds like a long way away but it's going to be here soon," he warned.

Sharply Lower Prices

Gumina noted that all is not "doom and gloom" in the private equity market. While buyers would like to see higher prices to help complete exit transactions, he said, at the same time prices are sharply lower for those interested in strategic acquisitions.

Regarding the risk-return ratio, Clare added, the debt market represents one of the best investment options. He suggested thinking about this market as two buckets. One is the debt of healthy companies returning 15% to 25%. The other is the debt of distressed companies that could be purchased to gain control of the business or drive it into a

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Garrett Moran, *Senior Managing Director, Blackstone Group*

restructuring. Such an approach will become increasingly popular, he said, though it is still early in the process. A lack of covenants and other mechanisms that would trigger default sooner is delaying inevitable restructurings. “Given the maturities, this is going to continue for four or five years at a minimum. We’re in the top of the first inning in terms of restructuring and distressed-debt opportunities.”

Forced divestitures will also provide opportunity, he said. Major companies under pressure, such as AIG and Citigroup, will need to unload desirable businesses. “It will take a while for buyer and seller expectations to line up.” However, “the companies that become available to us will be at valuations that are more attractive.”

Moderator Curt Cornwell, a partner in transaction services at PricewaterhouseCoopers, asked the panelists which industries were particularly interesting for distressed investing.

Gumina pointed to the retail sector. He said his firm is looking at retail opportunities even though the industry was “banged up” by extremely weak (Christmas) holiday spending. “We have to be creative. There are no straightforward LBOs to be done, but there are ways we can come in to shore up the capital structure or help buy a competitor and achieve synergy. It’s an area where having a good understanding of the space will matter.”

Gumina said his firm wasn’t seeing much opportunity in the health care sector, though it is considered a defensive investment. The sharp decline in consumer spending has extended to elective procedures. Uncertainty over the future of the industry under the Obama administration also makes health care less attractive, at least in the near term. Longer-term, he added, both retail and health care will provide opportunities for creative, smart strategies because they are undergoing dramatic change and because, in past recessions, the price to acquire competitors has declined.

Cornwell asked speakers about how federal government efforts to revive the economy through the Troubled Asset Relief Program (TARP) and other stimulus programs would affect private equity. According to Clare, TARP was a good step forward, but he said confidence would be critical in restoring economic growth. “We have to stop the massive fear and panic. Massive bank failure creates fear and panic, and that’s where we were headed. The TARP may not have been the most efficient way to go about it, but those big bold steps had to be taken.”

TARP and financial stimulus programs would provide opportunities for private equity to recapitalize and revamp the nation’s financial structure, he added. “I don’t think the government can afford to do it by itself and will need to create a structure that allows private capital to come in and build up an equity base for financial institutions.” He noted, however, that the process of restructuring and selling off bad assets had not even started. “It’s a bit early to jump in, and there’s no reward to being early.”

A second opportunity will come in remaking the financial sector itself, Clare predicted. “Restructuring the industry will create opportunities for new business models that people have not thought of yet and put private equity capital behind new financial businesses.”❖

'True Turnaround Specialists' Are Poised to Survive in Today's Challenging Private Equity Market

As the recession took its toll in the wake of the global financial crisis and bankruptcies rose, private equity started turning away from traditional leveraged deals and toward investment in distressed companies, according to speakers at the 2009 Wharton Private Equity & Venture Capital Conference.

Private equity specialists in distressed businesses, speaking on a panel titled "From Vultures to Saviors: How Distressed Investing Is Helping to Shape Tomorrow's Economy," said they expect a tidal wave of private equity deals made in 2006 and 2007 to go bad in the next few years. Given the number of opportunities and the lack of bankruptcy credit, many restructurings will occur outside of bankruptcy court and could result in swift liquidation. Kyle Cruz, managing director at Centerbridge Partners, explained that during the private equity boom, many deals were structured with loose covenants and too much debt.

John Caple, a principal at Bayside Capital, said the volume of impending credit defaults will make lenders more inclined to restructure deals outside of the bankruptcy courts, if only because it would be impossible to work through all of the court system's cases in a reasonable time frame. He said that if a lender has 20 companies in a distressed situation and 10 are making some payment, the bank may ask the private equity sponsors of those companies to put more into the deal rather than pursue the company in court. "It might not be the right thing to do," he said, "but it is the right thing to do given everything else they have to do."

Panel moderator David Gerson, a partner at the global law firm Morgan Lewis, asked how distressed deals differ from traditional private equity transactions that are based on leverage and the promise of unlocking value through operational expertise.

Michael Psaros, managing director at KPS Capital Partners, pointed out that cash usually isn't available to leverage in distressed situations. Most of the companies that his firm looks at have managers who are "catastrophic failures" and need to be replaced with new leadership, or a chief restructuring officer, to begin to create value. "That's our world," said Psaros, who added that after

20 years in the corporate restructuring field he had never seen so few true competitors in the business. "That's because it is hard. It is as different from the traditional LBO model as you can imagine."

Cruz pointed out another reason why distressed transactions are often more difficult to structure: A company's debt is frequently controlled by many parties that may have their own agendas, and distressed times can place more pressure on agenda differences. For example, lenders holding the primary debt may be more inclined to hold out for a better price than those who took on debt in the secondary market and are looking for a quick way to monetize their investment.

'Top Lines Getting Crushed'

Gerson asked how the panelists begin to think about valuation, given that prices have been dropping "like a sharp knife." Cruz acknowledged that valuations are challenging because it is unclear where the market bottom is, and it is increasingly difficult to forecast the future.

Psaros agreed that with the expectation that the biggest problem facing the industry in 2009 and 2010 will be falling demand. He described how a senior debt lender invited his firm to look at a deal for an RV manufacturer. The company produced 1,000 units in 2008 but had no orders backlogged for the first quarter of 2009. "What keeps me up at night?" he asked. "It's this whole 'catching a falling-knife' concept. We're seeing top lines getting crushed like I've never seen before." No matter how much a private equity firm paid for a company, he said, or how the deal is structured or how well the company is run, with revenue declines like those at the RV company, it is impossible to make money for investors.

Another problem, according to Michael Fieldstone, a principal at Sun Capital Partners, is that vendors are no longer as willing to prop up their customers. For the last 18 months, he said, many companies have taken it for granted that vendors would extend generous credit terms to keep their own products flowing. As credit markets weakened and financial firms pulled back, eroding balance sheets prevented companies from continuing to provide cheap credit to customers. The liquidation of Circuit City, he said, is an example of a company that went under quickly primarily because vendors stopped supporting the business.

The panelists stressed that in today's environment, with little or no leverage available, a buyout's success depends on operational basics. According to Caple, obvious, easy-to-correct problems must be present to justify keeping a company afloat. "In distressed situations, you are finding businesses that are wildly under-promising and spending money in really silly ways."

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> John Caple, *Principal, Bayside Capital*

Existing management is more likely to be replaced in a distressed situation than in a typical buyout deal where the company has positive earnings. Psaros said that before his firm takes on a distressed asset, it often installs a chief restructuring officer to ensure that honest and competent management is in place. He said his firm pulls from a network of individuals it can rely on for the job. KPS has a small, in-house "best practices" group, but appoints managers on a case-by-case basis. Fieldstone said his firm, too, has a pool of experienced former corporate executives that it draws on when a new management team is necessary. "This is a tough business. It's not for the fainthearted. This is complicated, and even more complicated with the liquidity crisis."

Psaros notes how, in many cases, a management change can drastically alter a company's prospects. "Sometimes all we have to do is change out a CEO and everybody below him just blossoms. On the other hand, we have literally had to fire everybody down to the shop floor level. Those two extremes are fascinating." He warned against buying into stereotypes about the management style of turnaround specialists. "Most people assume that the successful manager of a turnaround is a high-testosterone, chest-pounding professional. We have seen individuals with that kind of personality be successful, but we have also seen bookish, cerebral and methodical managers be equally successful. There's really no pattern." The key to managing a turnaround, he said, is to develop a plan and stick to it day by day, to ratchet up expectations. "Big-picture professionals have no place in a turnaround."

Obstacles to Exits

Even if a company can be restructured successfully, private equity firms face enormous obstacles in exiting investments today, the panelists said. Caple explained that in private equity's boom years, investors could exit deals in just a couple of years. Now the time frame is more likely to be five years. "So we will see very few exits in the near future," he said, referring to deals completed shortly before the credit crunch. "The market to sell businesses is nonexistent."

In the beginning of 2008, Fieldstone noted, buyers from India, China and other Asian nations did allow for some private equity exits, but that was because the dollar was weak. Now, with a stronger dollar, at least for the moment, even that exit door is closed.

According to Cruz, the private equity market is in the early stages of the distress cycle after an explosion of buyouts that peaked in the summer of 2007. Activity fell to more rational levels in 2008, and then ceased in mid-September of 2008, when Lehman Brothers filed for bankruptcy. "In this kind of macro-environment, by fall and for the next 12 to 24 months, you will see increasing true-distressed situations at companies that are coming back to lenders seeking relief," Cruz said. "We've seen some, but there is a lot more to come."

Karl Beinkampen, managing director at Morgan Stanley Alternative Investment Partners, predicted a bifurcation in the distressed market. He suggested that some buyers could handle deals for midsize firms when they run into trouble, but it isn't clear who would step in to take over the large companies that went private in the boom years and that may fail to meet loan covenants in 2012 and 2013.

The sharp economic downturn and tight credit markets are likely to lead to increased asset sales under Section 363 of the U.S. Bankruptcy Code. The panelists outlined strategies for acquiring distressed assets through bankruptcy. Sometimes it is best to take a "toehold" position in firms through debt to have more say in the firm's disposition, Caple said. Other times, it is best to stay on the sideline, especially as valuations fall fast. Psaros recommended basing strategy on the distressed company's capital structure. It is easier to do an out-of-court deal for a company with only one or two major lenders, he said. "If they have widely syndicated credit it is much harder to get together to do something out of court, especially in the environment today."

At the heart of the problem are the artificially high levels of credit and consumption in the last 24 months. "Much of what we have been using for historic reference was fundamentally flawed," Cruz noted. "We all wish we had a crystal ball, but all we can do is be extra-conservative and wait."

While the downturn is likely to generate "extraordinary opportunity," private equity firms that, early in the crisis, stepped into purchasing corporate debt at "low valuations" in the secondary market "got killed" as valuations kept on falling, Caple said. It is hard for a private equity firm to go back into this market if it has been burned recently. "How do you step in and say, 'Now is the time.' I think it is, but it's a tough thing to say."

The industry's tone, added Psaros, has changed dramatically with the disappearance of young "cowboys" working at hedge funds who rushed in and bought companies or their debt with little due diligence and loads of leverage. "It was nuts what happened in 2006, 2007 and early 2008 with these hedge funds."

Longer Investment Horizons

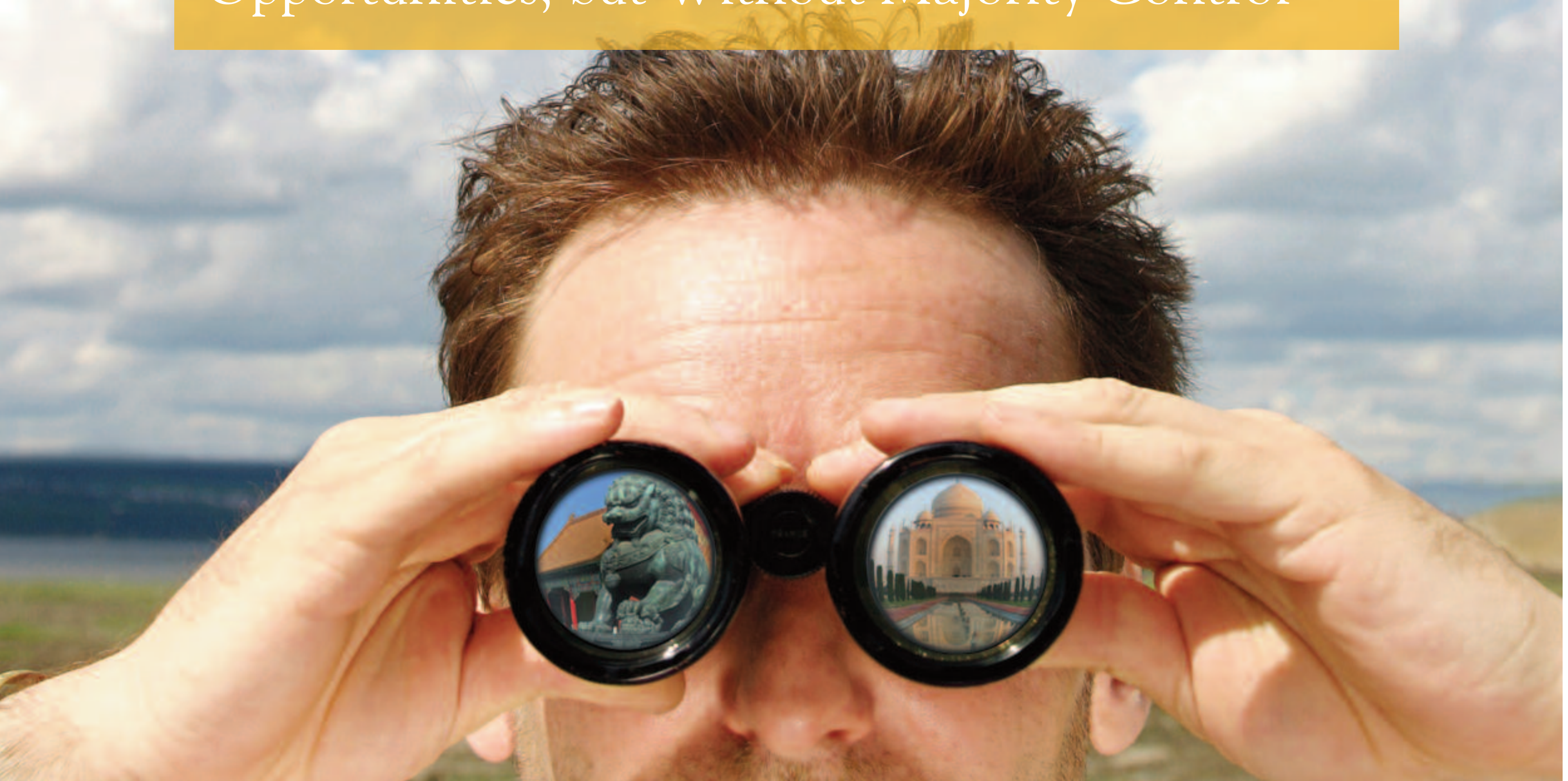
Gerson asked the panelists to describe the future of private equity finance. Caple responded that future deals will be all-equity transactions with an investment horizon of five to eight years, not the recently common three to five years. Psaros added that debtor-in-possession financing now lasts only six months with an up-front fee, and sometimes an additional exit fee, which he said is a recent development.

Gerson wondered whether difficulty arranging debtor-in-possession financing to carry companies until they can restructure would result in increasing "fire sale" liquidations, while Caple pointed out that, despite the economic downturn's severity, lenders are not forcing as many companies into bankruptcy as might be expected because they know debtor-in-possession financing is hard to arrange. "Many banks are being extraordinarily patient now. It's better for them to hang out and hope it gets better." Even if the economy recovered in two to three years, he said, the distress cycle will take five to seven years to complete given the financial markets' weakness.

According to Fieldstone, the economic collapse may be good in the long run because it can clean out the overcapacity and inefficiencies that had been generated, "like a forest fire that needs to happen." Investors have to be especially careful about selecting companies this year and next, he added, but good companies should survive and reap big returns when the economy recovers because there is significant investment capital on the sideline.

"I'd be hard-pressed to say I'm excited about the recession," Beinkampen said. But in a Darwinian view, today's business climate will winnow out less-focused private equity firms, leaving greater opportunity for those that survive. "Private equity won't disappear because of the restructuring," he noted. "But there's going to be a lot fewer folks overall, and that will be good for the buyout business."❖

India and China Offer Attractive Private Equity Opportunities, but Without Majority Control



Despite the recent wave of corporate scandals, severe declines in local stock markets from their peaks and a challenging regulatory environment, strong fundamentals in China and India continue to offer some highly attractive opportunities for prudent private equity (PE) investors. But to succeed, PE investments must be carefully planned and fully supported with a regional presence in order to identify attractive potential opportunities and understand competitive threats to Western companies.

To learn more about PE investment in this region, members of Wharton's Private Equity Club (WPEC) recently interviewed Dalip Pathak of Warburg Pincus and Alastair Gibbons of Bridgepoint Capital about their views on PE investing in today's transformed environment. Dalip Pathak heads Warburg Pincus' London office and is responsible for the firm's investment activities in Europe and India. Pathak is also a member of the Advisory Council of the Emerging Markets Private Equity Association in Washington, D.C. Alastair Gibbons is a partner at Bridgepoint Capital. He led Bridgepoint's United Kingdom business until 2001 and then its German business until 2006. He now focuses on Bridgepoint's business development and cross-border investments.

An edited transcript of the interview appears to the right.

WPEC: Following the recent scandals in emerging markets, such as Satyam in India, have PE firms re-evaluated their approaches to developing markets?

Dalip Pathak: The Satyam scandal in India is obviously very unfortunate. It was shocking both in terms of the fraud committed and equally in the length of time it took for the situation to be detected. It was also one of India's companies which was more exposed to international business and capital markets; hence, one would have expected higher standards of corporate behavior. This occurrence has obviously made investors more cautious and will make them more demanding in terms of transparency, which in any case is good.

However, one should remember that Satyam is not representative of Indian companies at large. With regard to India, since the opening of the economy in 1991, the country has seen huge improvements in both capital markets regulation and in corporate governance. In fact, based on my 10 years' experience in the Far East and six years' experience in Europe, I am convinced that the top-

tier companies in India pursue high standards of corporate governance, judged by international benchmarks. Even some medium-size companies in India compare favorably with similar companies in industrialized countries. The reason for this is very simple: Medium-size companies in India need to access capital markets because of the traditional shortage of private capital, whereas in other parts of the world, similar-size companies are often privately or bank-funded and can get away with being less transparent.

The capital markets impose higher standards of governance on these Indian listed companies. Furthermore, Indian capital markets regulation today is of a high standard. However, while the regulations per se are of a high standard, enforcement has the potential to improve further. Despite this, Satyam and other scandals have happened. But incidents such as Enron, Madoff and Parmalat prove that scandals of this sort happen not just in Asia. Rational and long-term investors should no more shy away from Asia as a whole and India in particular due to Satyam than they should from the U.S. due to Enron or Madoff. It is understandable if they are more cautious, and that is only appropriate. But the inability to put the situation in perspective will be unfortunate both for India and for investors.

WPEC: Given the dramatic decline in Asian stock markets [in early 2009], how have you adapted your investment strategy? Have valuations and management styles adjusted to those new levels of growth?

Pathak: The decline in Asian stock markets has been sharper than that in the U.S. or the U.K. These markets are inherently more volatile because they are not broad and deep, and their perceived risk is higher. That said, even at the peak of the current crisis it has been difficult to identify high-quality companies in India which one would consider "cheap buys." Whilst GDP growth in Asia is currently lower than in the past, in countries such as India and China, growth rates are still substantially positive, unlike the GDP contraction that we see in Europe.

"Whilst GDP growth in Asia is currently lower than in the past, in countries such as India and China, growth rates are still substantially positive, unlike the GDP contraction that we see in Europe."

Dalip Pathak, *Warburg Pincus*

My suspicion is that the decline in valuations goes beyond a mere reflection of the earnings potential of the corporate sector in Asia. Liquidity has been sucked out of Asian markets due to redemption pressures in industrialized economies, and in most cases, this has penalized valuations disproportionately to the earnings potential or prospects of companies. From a capital markets (as opposed to an economic) perspective, emerging market equities have historically been more volatile than developed economies' markets because the marginal dollar (i.e., the dollar which drives near-term volatility) is typically "high-velocity" capital. That is, investors who are seeking "growth at reasonable value" will reallocate capital to emerging markets when reasonable values are not achievable in the developed markets, which is what happened in the late 1990s and in the mid 2000s.

As emerging markets begin to correct, this capital can go back home quite abruptly, leaving the emerging markets without a bid. This is a typical "flight" cycle. What happened this time around is that volatility in developed markets exceeded any precedent experience, resulting not just in risk capital going back home, but in its total capital destruction. So the redemption and margin wave that struck hedge funds and most high-beta capital after Lehman's bankruptcy had a much more dramatic effect than during prior cycles. In fact, these precipitous declines in emerging market equities took place despite the underlying and relatively favorable fundamental performance of the economies, financial system and individual companies in the respective markets.

A key question now, since developed markets are still in significant disarray, is whether emerging markets (especially China and India, which both have different, but very attractive underpinnings for growth) can develop more advanced sources of capital, perhaps even internally. This is important because liquidity from foreign flows might be slower to return this time, yet there is a significant need for non-domestic savings, at least in India, to support the high levels of growth in the recent past. Management teams were slow to recognize the oncoming economic

tsunami that hit in 2008. For example, there was a sense in India that the country was somewhat immune from the world crisis. Furthermore, the severity of the global crisis was underestimated. However, by November 2008, most Indian businessmen had recognized that India would not go untouched, and subsequently have been quick to reduce costs or take other measures appropriate to the situation.

WPEC: Do you think there will be a distressed cycle in Asia that mirrors the U.S.? What factors limit PE firms' ability to execute LBOs [leveraged buyouts] in Asia, and how will those evolve?

Pathak: LBOs in much of Asia are rare events. The reasons for this, particularly in India, are fairly straightforward. Most Indian banks, relative to international banks, have small balance sheets. There are strict central bank regulations restricting how much Indian banks can lend to any one company, and this ultimately controls the amount of debt that any one company can have on its balance sheet, making the whole concept of LBOs in India quite alien. Furthermore, Indian companies are typically founder-family owned or controlled, and Indian families are disinclined to forego control for financial gain, even if the company is not performing well, or if they can achieve "super-normal" gains by divesting.

In Asia, this is very much a cultural factor, and unless this attitude changes, it will be difficult for LBOs to thrive. In addition, most of Asia does not have the kind of bankruptcy laws that exist in the U.S. For this and for other cultural reasons, you do not come across Indian banks foreclosing on companies or assets. They are more inclined to try and reach settlement with borrowers. If this were not the case, we would probably see the kind of disposals and distressed asset sales that we see in the West.

As Asian economies, including India, develop, we are likely to see the emergence of bankruptcy laws, more M&A and LBOs. In fact it is believed that there is a high likelihood that post the April-May 2009 elections in India, bankruptcy laws could well be introduced. This is desirable because the current regime of regulation permits poor governance and inefficient use of capital. Worse still, it punishes the performance of well-managed, high-quality companies by keeping inefficient companies alive supported by government banks or even private banks.

The promulgation of bankruptcy laws will create a market for M&A and restructurings which currently, though not non-existent, is quite small. In conclusion, I think it is fair to say that the secular trend is for Asian economies, particularly India and China, to grow at significantly higher rates than the U.S. or economies in Europe. The road will be bumpy on occasion, because development is not a neat process. However, it is this very growth, together with occasional discontinuities, that will continue to create unusual profit opportunities.

WPEC: How relevant are developing markets, such as India and China, to PE firms traditionally focused on Europe?

Alastair Gibbons: The developing markets are becoming more relevant to PE equity firms with a European investing focus. In evaluating potential deals or portfolio company performance in Europe, it is important to understand how value is impacted by competitive threats to European companies from these markets and also the opportunities that are available in India and China from improved commercial sourcing.

A secondary opportunity to develop sales channels in those countries is also relevant, albeit much more difficult to achieve in practice. In the future, we also expect more activity from Chinese and Indian companies looking to acquire businesses in Europe. Consequently, as we consider exit opportunities, we will increasingly extend our net to Asia for prospective acquirers. As a middle-market European firm, we do not envisage setting up a local team in these countries to compete with local private equity firms for local deals in the near term. However, for the reasons mentioned above, we are likely to establish representative offices to add value to our portfolio companies.

WPEC: How have Western PE firms needed to adapt their investment styles for the Asian markets? Which specific markets are most appealing and why?

Gibbons: Western PE firms have had to accept that acquisition of majority stakes providing outright control is extremely difficult to achieve and, hence, have had to shift their strategy to holding sizable minority stakes. The degree of control afforded is necessarily less and [therefore] more time is spent on goal alignment and relationship building with the majority shareholder. The PE markets today are largely growth-capital rather than buyout oriented, and less leverage is available to be structured into deals. [This means that] a higher proportion of target returns must come from growth in earnings, either revenue-driven or cost- and efficiency-improvement-driven.

Regarding specific attractive markets, China and India are both interesting as they offer enormous scale, strong long-term growth, burgeoning development of a sizable consumer-oriented middle class, low cost and an increasingly educated labor force. Furthermore, PE markets in these countries are still relatively nascent. They also present massive challenges, not least of which are weak corporate governance regimes, unreliable judicial systems and regulatory regimes, plus widespread corruption. Overlay on to that markedly different cultures and a language barrier (for China) as well as an inadequate supply of well-trained or experienced managers, and we conclude that market entry must be carefully planned and staged.❖