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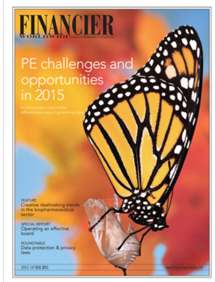
PE challenges and opportunities in 2015



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BY

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Like many other facets of the financial services industry, the private equity (PE) asset class has endured a turbulent and difficult period since the onset of the financial crisis. Critics of the industry were quick to colour the PE space as a den of iniquity, a place for vultures and destroyers of jobs. In recent years, the sector has been required to comply with an increasingly tight set of regulatory requirements.

Regulation in the PE industry has been stringent and free flowing. There has been a plethora of regulation and legislation handed down to PE over the last decade or so, as Johan Terblanche, a partner at Dechert LLP, explains. “The industry has seen significant increases in regulatory and compliance burdens and has adapted well following a relatively slow start,” he says. “Most PE houses understand that they need to adapt quickly. They have allocated extra resources to the regulatory and compliance functions and have improved the level of transparency and reporting to investors, not only to comply with mandatory regulatory requirements, but often also in an effort to meet investor requirements. In addition to great strides made in transparency generally, the level of detail and disclosure in relation to valuation and allocation of expenses have increased in particular, fuelled by the SEC and other regulators' focus on these items and the increased use of co-investments and managed accounts."

The asset class has seen a number of changes to the pre-existing regulatory and legislative landscape, with measures such as FATCA, AIFMD and MiFID all having a substantial impact. Such changes are far from over, as there is likely to be more in the pipelines for PE firms. Accordingly, the industry will be required to demonstrate agility and dynamism to quickly and effectively adapt going forward.

PE deal activity

Despite the ever stringent regulatory requirements being foisted upon the PE industry, the sector has responded admirably of late, more than keeping its head above water. Its robustness can be seen in recent global deal activity. Transactions in the PE industry climbed considerably in 2014, with deal values reaching $3.5 trillion, an increase of 47 percent on 2013, according to Thomson Reuters. PE exit volumes also reached record levels in 2014.

Optimism surrounding the PE space persisted despite the considerable lack of leveraged buyout (LBO) deals announced last year. Even without LBOs there was still around $562bn of global PE M&A activity in 2014, much of which was focused on the middle market, representing a near decade long high point for the industry, and an increase of 43 percent over 2013. PE deals accounted for 21.9 percent of total global M&A activity, a figure believed to be an all-time high. The PE secondaries market also enjoyed a notable year in 2014, with record volume, according to Preqin.

One of the biggest contributing factors to the impressive performance of the PE sector in the US was likely the availability of cheap and abundant credit. This saw liquidity flowing into all corners of the US market. Many commentators expect this overabundance of cheap credit to continue throughout 2015, save for a dramatic increase in interest rates. Furthermore, according to a study from Roland Berger Strategy Consultants, 34 percent of PE firms plan to go on investing in new companies this year, and 31 percent intend to continue making strategic and operational improvements to portfolio companies going forward.

Chinese PE activity, by contrast, was rather more subdued. "In 2014, the gap between the performance of the private equity industry in China and the US opened wide," says Peter Fuhrman, chairman and founder of China First Capital, a China-focused global investment bank. "The US had a record-breaking year, with 10-year net annualised return hitting 14.6 percent. Final data is still coming in, but it appears certain US PE raised more capital more quickly and returned more profits to LPs than any year previously. China, on the other hand, had another so-so year. Exits picked up over 2013, but still remain significantly below highs reached in 2011. As a result, profit distributions to LPs and closing of new China-focused funds are also well down on previous highs. While IPO exits for Chinese companies in the US, Hong Kong and China reached 221, compared to only 66 in 2013, the ultimate measure of success in PE investing is not the number of IPOs; it's the amount of capital and profits paid back to LP investors. This is China PE's greatest weakness."

Clearly, the last few years have been productive and profitable for PE firms in most major markets, which only serves to magnify the struggles experienced in the industry in China. So what accounts for this poor performance compared to the US? "One overlooked reason is that China PE has lost the knack of investing and exiting profitably from Chinese industrial and manufacturing companies," points out Mr Fuhrman. "Broadly speaking, this sector was the focus of about half the PE deals done up to 2011, when new deals peaked. That mirrors the fact manufacturing accounts for half of China's GDP and traditionally has achieved high levels – over 30 percent – of value-added."

Exits

The US PE industry recorded its highest ever exit volume last year, according to the Private Equity Growth Capital Council. Exit volumes in the US reached $257bn last year, up 35 percent from 2013.

Globally, PE-backed IPOs were strong, particularly in Europe and the Asia-Pacific region. According to Bain & Company's 'Global Private Equity Report 2015', there was a notable increase in Asia-Pacific IPO exits last year, primarily due to the reopening of China's IPO market following a 14-month moratorium on new offerings. China has proved a critical venue for Asia-Pacific IPOs. Bain's data suggests that even excluding the $21.8bn IPO of e-commerce giant Alibaba, the value of PE-backed IPOs in the Asia-Pacific region in 2014 was still three times what it had been in 2013.

> ***"Prudent fund managers will need to find creative and differentiated ways of generating value if they hope to deliver strong returns to their investors."***

Given the PE industry's 2014 performance, there is considerable pressure on the asset class to repeat the trick this year. A number of opportunities are available, with some commentators suggesting that distressed investors in particular should enjoy a productive year.

Yet, despite some of the positive indicators, the year is unlikely to be plain sailing, and there will be challenges to overcome. Low levels of growth, investment discipline and the rising prevalence of leverage in the second-hand market are just a few issues the industry faces.

Fundraising

On the whole, 2014 was a strong year of fundraising in the PE space, albeit with mixed regional results. Fundraising in the US was down, but Europe enjoyed a stellar 2014, with a pipeline worth more than €17.5bn. Capital commitments came from the usual variety of sources, including pension funds, sovereign wealth funds, wealthy families and other investors to name just a few, all of which have contributed greatly to PE funds over the last 12 months. Analysts are increasingly confident about the sector's prospects for the remainder of this year.

So what, then, is the outlook for fundraising in 2015? For some analysts, the overabundance of dry powder in the PE space will have a negative effect. Dry powder reserves climbed to $467bn as of December 2014, up from the $399bn recorded a year earlier. The past two years of strong fundraising will create strong headwinds for fund managers this year, particularly in the US. Furthermore, the record number of funds in the marketplace will also make fundraising much harder.

In China, fundraising will also be difficult, according to Mr Fuhrman. "China PE firms' poor pay-out performance to LPs is already having an adverse impact on the China PE industry. It is getting harder for most China PE firms to raise new capital. If this trend continues, there will be two negative consequences. First, the China PE industry, now the second largest in the world, will shrink in size. Second, and more damaging for China's overall economic competitiveness, the investment capital available for Chinese companies will decline. PE capital has provided over the past decade much-needed fuel for the growth of China's private sector," he adds.

In Europe, 2015 may well be a red letter year for fundraising activities, permeated by a sense of cautious optimism. "A number of PE firms are going to market in 2015 and the target sizes of most funds are larger than they were for predecessor funds," notes Mr Terblanche. "This reflects optimism in relation to the ability to raise capital, supported by a number of industry surveys which show that the majority of investors expect to increase capital allocation to private equity strategies and PE houses' belief that they will be able to deploy larger amounts of capital in their respective strategies. In determining to which funds they allocate capital, LPs are still largely driven by track record and clarity of strategy, while organisational robustness seems to be playing an increasingly important role in LP due diligence."

Oil

The oil industry has been the subject of much debate over the course of the last 12 months, with prices plummeting since June 2014. Unsurprisingly, the PE industry has taken note. It would appear that a number of PE heavyweights have earmarked the oil space for significant investment, despite many notable companies taking sizable losses on oil over the latter stages of 2014. The Blackstone Group has allocated around $9bn to the industry and launched a $4.5bn energy fund in February. According to Blackstone, the firm is positioned to "take full advantage of the significant recent cyclical downturn in oil and gas prices". EnCap and Warburg Pincus are believed to have around $5bn and $4bn respectively to invest in the space. KKR also has an estimated $3bn oil and gas fund. The size of these dedicated funds, and the long term nature of PE investing, lend themselves nicely to the distressed oil and gas industry and its associated volatility. Look for PE firms to be particularly active in the energy sector as 2015 unfolds.

Challenges

Though there is optimism in the industry, there are still causes for concern. In addition to the threat of further regulatory and legislative pressures, the PE sector will have to face a number of other challenges in 2015. Generally, the European M&A markets are expected to see slower growth this year than in recent years. The UK, Europe's biggest market for deals, will likely only see around an increase of 2 percent this year, while in Germany that figure is likely to be just 1.7 percent.

For European firms, one of the greatest challenges will be competition with funds from abroad. Europe is a hotbed of both intellectual property and capital, and houses healthy and attractive companies in various sectors. Accordingly, investors from the US, the Middle East and the Asia-Pacific region have shown a significant interest in pursuing deals in Europe. Local PE funds will need to overcome considerable opposition from foreign investors if they wish to secure the best deals.

Increased competition will make it harder for firms to find attractive and viable investment opportunities, adversely affecting returns. 2014 saw around 1800 European deals completed, and if 2015 follows suit it will be another notable year for the PE sector. Increased competition and record levels of dry powder may have a knock-on effect on acquisition prices, which could easily rise. Prudent fund managers will need to find creative and differentiated ways of generating value if they hope to deliver strong returns to their investors.

Conclusion

When assessing the PE industry, it is important to bear in mind that we are only seven or eight years removed from the worst financial crisis in a generation. While a return to the unprecedented glory years of the mid 2000s is highly unlikely, the strength of the global PE industry in 2015 is impressive.