Hard Days and Sleepless Nights for Private Equity Firms

Published : February 12, 2003 in Knowledge@Wharton

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Today's business environment is similar in ways to the early 1990s when private equity firms rose up to restructure mountains of bad debt and went on to cash out in the ensuing bull market.

But while opportunities are out there, it is harder to make deals work than it was a decade ago, according to two leading private equity players who participated in Wharton's annual private equity conference held Jan. 24.

Leon Black, founding partner of Apollo Management, L.P., and Lawrence Schloss, global head of the private equity group at Credit Suisse First Boston, both agreed that today's tough times may lead to big rewards for those able to weather the financial and geopolitical hurdles weighing on markets today.

"Availability of Capital Is Incredibly Scarce"

Black, former co-head of the corporate finance department at Drexel Burnham Lambert, founded Apollo in 1990 after Drexel collapsed. Apollo quickly became a pioneer in buying and restructuring distressed debt. The company has since invested about $14 billion in corporations, $3.5 billion in real estate and several billion in capital markets.

"I spent 13 years at Drexel. The first 12 were like a rocket ship going onward and upward and the last was an absolute nightmare which ended in a real crash and burn," he said. "When we founded Apollo the environment was actually fairly similar to today."

Black said his father, a rabbi who later became a businessman, taught him that careful study and debate should precede decision-making. He took that approach to evaluating investments at Apollo. But Black also said Apollo benefited in its early days from strong backing by Credit Lyonnais, which had built relationships with Apollo's founders at Drexel. While he used to think that success was primarily the result of hard work and reasoned decision-making, "I've learned with the luxury of middle age …to have great respect for the benefit of experience and just plain good luck."

Black said the current business environment leaves him sleepless for two completely different reasons. As the manager of a portfolio with 20 investments, he is kept awake by frustration and aggravation with the economy. But as the custodian of $3.8 billion in uninvested fund dollars, he said he lays awake buoyed by excitement and a hunger for promising new deals.

Three of his portfolio companies are currently performing below expectations and need new capital, Black noted, while six are performing better than expected. The rest are doing well, "but either their stock price or their private valuation is underwater and don't reflect the value we recognize, and there is little chance of exit until there is an overall improvement in the economy."

From 1990 to 1992 Apollo invested $2.5 billion in troubled companies "because we viewed distressed opportunities as far and away the best risk-reward game. At that time most private equity firms sat on their hands because they did not want to play in an arena where they would be buying securities without absolute control from day one." Today, he said, there is less capital available than when he was starting

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out.

Black emphasized the importance of financial engineering in his firm's business. "Many of the organizations competing to occupy the same space as Apollo downplay financial engineering. One cannot ignore the importance of managing the balance sheet … I don't mean in lieu of an operating focus. I mean in addition to it."

He would prefer to do classic leveraged buyouts or corporate partnerships, but today – as in the early 1990s – opportunity lies in distressed debt.

Apollo's investment policy has always been geared to cash flow, he added, so it was not wrapped up in the enthusiasm for telecom and tech companies. "We believe companies without cash flow are almost impossible to restructure." Apollo won't consider investing in companies that are so large that Apollo's capital would have no influence or so small that the company would not have an impact in its markets.

Today private equity investing is marked by little liquidity and low prices. The consolidation of the U.S. banking industry since Black created Apollo leaves far fewer lenders; meanwhile Japanese banks are not the force they were in 1990. As a result private equity firms need to put more capital at risk in deals – or about 40% of transactions in 2002 compared to 30% in 1995 and 10% in 1988, said Black.

The main difference in today's market is that most of the debt is owned by banks rather than the high-yield, or junk, bonds that were so closely associated with Drexel. Even though bank loan rates are low, Black pointed out, that does not help his company put together deals because banks are seeking greater equity participation. "The good news is that rates are lower. The bad news – which is more relevant – is the availability of capital is incredibly scarce today."

According to Black, banks were once willing to lend private equity firms 3.5 times cash flow to invest in companies. Now, they want 5.5 times cash flow. To get some deals done, private equity firms have teamed together and pooled their capital, although Black remains guarded about that approach.

Many of the players in private equity remain the same as in the early 1990s, he added. Most buyers of distressed debt are hedge funds out to buy a security at 40 or 50 cents on the dollar and flip it for 70 cents on the dollar. "That's not a bad business in the right environment. Very few want to play the catalytic role of really taking control of companies."

In the early 1990s, he said, there were hundreds of potential investment prospects. Today, with a market overhang of half a trillion in distressed securities, there are even more companies to consider, but their quality is lower than a decade ago. "Today the numbers are even greater, but you really have to sift through them a lot more carefully since at least a third of them are telecom companies and high-tech companies that really don't have a reason to exist at the end of the day."

Finally, Black said, Apollo is beginning to make investments abroad. Previously the availability of deals in the United States and the complexity of restructuring bad debt in countries with different legal and accounting standards – not to mention language barriers – had kept the company at home. But in the past five years, Apollo's real estate wing has put about a third of its capital into European investments and is now considering buying opportunities in Japan.

On the corporate side, Apollo recently took control of a German cable company and is considering two other European deals. "I would say for the first time there is a nascent distressed market emerging in Europe which is getting pretty interesting," Black said. "We're dipping a few small toes in over there."

New Focus on Europe

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Lawrence Schloss, managing director of Credit Suisse First Boston and global head of its private equity group in New York, also noted similarities between today's private equity market and that of the early 1990s. But he, too, said today's climate is even tougher. "People are relearning again that there are business cycles."

Schloss outlined major business and economic trends driving today's markets including the fall of Communism, deregulation, globalization, diminished pricing power, industry consolidation, interconnectedness of global capital, and new technology and its impact on productivity. In addition, the creation of the euro is poised to play a big part in capital markets.

"I can't tell you how complex it used to be to deal with each country with all their taxes and all their rules," he said. "The euro smoothes things out and when you smooth things out you discover these guys are completely inefficient. The euro will ripple through the economy for the next 10 years."

In addition to these economic forces, there are geopolitical issues that are bound to have an impact on private equity markets, Schloss noted. At the top of that list is Iraq. "Iraq is today's thing to worry about but there is still a huge problem in the Middle East. People are petrified about another terrorist attack."

Other global concerns include a growing divide between the United States and Europe and rising anti-U.S. sentiment that could lead to harmful protectionist policies. Schloss said Japan continues to be a drag on the global economy and Russia will rise to become a growing force. Finally, there is North Korea. "Markets don't like it when somebody says, 'I have a nuclear bomb and it's pointed at you.'"

At home, Schloss said the Republican majority in Congress will push to cut taxes and increase spending in an attempt to turn the economy around, but those policies could have a long-term impact on the nation's debt. As if that weren't enough to digest, markets have been hurt by a loss of investor confidence fueled by the stock market decline that has wiped out $6 trillion in equity and corporate scandals. "People don't like what they see. Someone lost $6 trillion and they're pretty mad about it."

Against this backdrop private equity investments have some strengths, said Schloss. First, the industry has knowledgeable accountants and would not be caught up in the irregularities that occurred at publicly held companies. Second, private equity firms can align themselves with management so that executives are clearly concentrated on investors' best interests: "Everyone is focused on the mission and the mission is to make money."

Third, with a credit-crunch limiting bank lending, private equity now has a better chance of getting access to attractive deals. And venture capitalists no longer present much competition. "The VC guys are beside themselves. They had too much in technology," he said.

Schloss predicted private equity investment will continue to focus more intensely on Europe. In 1998, Europe accounted for 21% of all buyout transactions. In 2002, he said, 62% of the deals were done in Europe.

With the stock market stagnant and the appetite for initial public offerings nonexistent, companies will look to private equity firms for financing. He said he has become noticeably more popular in recent months. "The private equity guys have the money," he told the conference, which included students and private equity managers. "You've got the money. You've got the vision. You're ready to go. In these kinds of markets, being focused and having people ready to go is a great thing."

Lower interest rates have helped support consumer spending and that, in turn, has kept the economy running stronger than might be expected, he noted. A the same time, uncertainty about Iraq and other

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global issues is creating hesitancy in the broader economy. "In 2002 there was so much bad news, so many macro issues, that as a manager you could not figure out if you should build a new plant or make any hires. So nothing happens. Nothing is not good for the economy."

While Schloss said the default rate on corporate debt is high, he forecast that the worst is over, adding, however, that while the broad stock indexes have been down for three years in a row, share prices could still be considered high.

The financial problems of the last few years have, not surprisingly, led to pressure on private equity managers from their limited partners. "If you wandered and let your mind stray into tech and telecom, you're just embarrassed," he said. Limited partners are somewhat more understanding about bad investments in industrial companies.

With the public markets shut down, investors now have no way to exit from their private equity plays, extending their partners' holding time: "The longer you hold a private business the harder it is to focus on the mission and there is more uncertainty. Private equity is harder than it used to be."

He said capital flows into private equity could be constricted in the future as large funds with losses in the public markets need to reduce their private positions to maintain their stated asset-allocation mix.

Turning back to the economy, Schloss said that while the consumer remains strong, in part due to moderate unemployment rates, there is now little pent-up demand for housing. He predicted continued disappointing corporate earnings and, with industrial capacity at only 75%, there is little cause to expect expansion in that sector.

But uncertainty creates opportunity for private equity firms, said Schloss, reminding his audience that investments made during the low-point in the economic cycle in early 1990s were primed for big payoffs later. "Most private equity guys spent the last two years getting their portfolios in order. They're starting to pick their heads up.

"People are going to make some great investments," Schloss predicted, "and they're going to make a lot of money two or three years from now."

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