

2011 Wharton Private Equity Review:

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GRADUALLY  
REGAINING GROUND



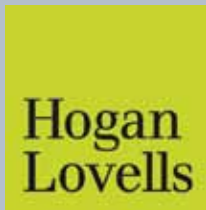
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## 2011 Wharton Private Equity Review:

# GRADUALLY REGAINING GROUND

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The financial meltdown of 2008-2009 and the resulting global recession dealt a painful blow to private equity investing, and the industry is still recovering. In this special report, based on the 2011 Wharton Private Equity and Venture Capital Conference, Knowledge@Wharton examines the industry's gradual comeback.

## CONTENTS

### **Battling Headwinds: Private Equity's 'Bright Future' in Technology and Developing Economies**

3

Forward-looking private equity investors can still reap strong returns from global growth opportunities, despite the powerful headwinds that are buffeting the U.S. economy. That was the assessment of Glenn Hutchins, co-founder and co-chief executive of private equity firm Silver Lake, in a keynote address during the 2011 Wharton Private Equity and Venture Capital Conference. Although high unemployment, excess capacity and a backlog of unsold housing remain problematic in the U.S., technology and booming economies in Asia and the developing world offer a wealth of prospective investments, Hutchins said.

### **As 'Megadeals' Lose Luster, Mid-sized Companies Are Becoming More Attractive**

6

Private equity investors are increasingly focused on strong middle-market companies that are ready to expand. Investments in such companies demand less capital than larger deals and have greater flexibility when it comes to cashing out. This makes middle-market investing particularly attractive to private equity firms at a time when money remains tight and fund-raising is challenging in the wake of the global recession.

### **Where Markets Are Hot: Opportunities for Venture Capitalists Across the Globe**

9

The prospect of reaching vast numbers of new middle class consumers in emerging markets is a driving force in international private equity and venture capital. In China, India, Southeast Europe and Latin America, sizable populations of young consumers are eager to enjoy the goods and services available to those in the United States and other developed countries. Top targets for investment in these emerging markets include companies in the Internet, financial services and clean technology sectors.

### **Let's Make a Deal: Distressed Companies Appear Ready to Turn to Private Equity**

13

Troubled companies that have been hoping for better times will soon have to turn to private equity investors for sorely needed funds. That was the consensus of a panel on distressed investing at the 2011 Wharton Private Equity and Venture Capital Conference. Companies that have renegotiated bank loans six or seven times will need to resort to other options, the panelists said. Among the sectors most likely to provide distressed opportunities are real estate, finance and health care.



## Battling Headwinds: Private Equity's 'Bright Future' in Technology and Developing Economies

Forward-looking private equity investors can reap strong returns from global growth opportunities, despite the powerful headwinds that are buffeting the U.S. economy. That was the assessment of Glenn Hutchins, co-founder and co-chief executive of Silver Lake, a global private investment firm, in a keynote address during the 2011 Wharton Private Equity and Venture Capital Conference.

Technology and booming economies in Asia and the developing world offer a wealth of prospective investments, ranging from health care to wireless technology, Hutchins said in a talk titled, "Endgame: The New Economy." "If you can position yourself in a growing part of the U.S. and the global economy, there is a very bright future ahead of you," noted Hutchins, whose firm has \$14 billion in assets and offices in New York, California, Europe and Asia.

Hutchins called the 2008 global financial collapse the worst he has seen in his business career. The former adviser to President Clinton on health care and economic policy said the crisis is a reminder that even the best investors can be "hurt badly" if they misread economic conditions.

Lingering effects of the crisis still haunt the economy, he noted. For example, the current recovery is far weaker than those that have typically followed a U.S. downturn. "Usually, the deeper down you go the steeper you come back," said Hutchins, who is chairman of SunGard Corp., a software and technology services provider, and a director of companies

including telecommunications provider MCI and TD Ameritrade Holding Corp., a financial services firm. But this time, the "bounce back is anemic by contrast."

Among the major signs of weakness that he cited:

- **Unemployment:** Hutchins called joblessness the single most important part of the economic picture. Laid-off workers have currently been unemployed for an average of 34.2 weeks — more than 60% longer than in past economic cycles. "This has long-term consequences for families and kids," he pointed out, noting that it becomes much harder for people to find work after six months of unemployment since their skills and business networks begin to grow stale.

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Technology and booming economies in Asia and the developing world offer a wealth of prospective investments, ranging from health care to wireless technology.

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Meanwhile, more jobs have been permanently lost in the latest decline than in previous cycles. While laid-off workers were frequently hired back by their employers, today's unemployed must often find new jobs with other companies, Hutchins said. New jobs most often come from small companies that are expanding, he added, but the funds

available for such expansions have “declined precipitously” in the wake of the global financial meltdown.

- **Excess capacity:** Only about 76% of U.S. manufacturing capacity is now in use, Hutchins said, compared with the historic norm of 82%. And the service sector, a source of growth in past recoveries, also lags because these jobs are increasingly outsourced to other countries. The rate of economic growth in the U.S. service sector is now just 0.5%, compared with more than 2% in the previous two recoveries. “The services engine has slowed down,” said Hutchins. “An increasing amount of professional services — architecture, engineering, consulting, legal, accounting — has gradually been able to migrate outside the United States.”

Major corporations are increasingly relocating to other countries as well. “People understand that GDP has moved outside the developed world. They get that jobs have gone with it. But what they really don’t understand is that corporate activity has gone, too,” Hutchins said. Nineteen of the world’s 25 largest companies in market value were based in the United States in 1999, he noted, compared with just 14 today.

- **Real estate:** Housing remains the heaviest drag on the recovery, said Hutchins. The U.S. housing industry currently has a 24-month supply of unsold homes — including those in foreclosure — or four times what economists consider the optimal level of supply. Weak housing prices reflect this unsold inventory: While prices typically show a 26% gain in the first year of a recovery, in 2010, home prices were down 1% from the previous year.

The impact of the 30-year buildup of debt that preceded the 2008 financial crisis is also impeding the recovery. Debt reached 350% of the U.S. Gross Domestic Product (GDP) that year, according to Hutchins — more than twice the level that preceded the Great Depression. “This was not a product of one decision,” he said of the vast buildup before the recent crisis. “It was not a product of one bubble. This is 30 years of excess in borrowing in almost every sector of our society.”

Such borrowing “sticks with you,” he noted,

making it extremely difficult for the economy to grow while government, consumers and businesses shed debt. Consumer borrowing fell for a record nine straight quarters as of the end of 2010, for example, and consumers have lost some \$1 trillion in purchasing power as a result of the recession. Debt-burdened consumers are reluctant to borrow, even as credit becomes more readily available.

This increase in saving is taking place at “just the wrong time,” since what the economy needs most is a surge in demand from consumers, whose spending accounts for some 70% of GDP. Investors must thus make a judgment about whether consumers will go back to “aggressive borrowing and shopping,” he said.

### The Weight of Budget Deficits

Also weighing on the economy are government budget deficits around the world, which Hutchins called a major threat to the recovery. But “you can’t take the patient off life support until he can sustain himself,” he added. “You have to take the stimulus out of the economy relatively gently,” since a sharp pullback could trigger the kind of double-dip downturn that the United States suffered in 1937.

At the same time, Hutchins applauded the deficit-cutting moves that the co-chairmen of the bipartisan National Commission on Fiscal Responsibility and Reform recommended last December. “There’s a roadmap already out there. The question is, do we have the political will to do it?”

Looking five years ahead, Hutchins predicted the global economy will expand through 2015, with most of the growth coming in Asia and other parts of the developing world. Silver Lake is gearing up for this, he said. Employees are told, “You may not like the food. You may not like the jet lag. You may not like missing your kid’s soccer game, but you’ve got to go” to the emerging markets, particularly Asia. “Not only that, but we’re going to move you there.”

Middle class consumers in emerging markets often look for products that are far different from what U.S. companies produce, Hutchins added. He pointed to the popularity of ultra low-cost

Nano cars in developing countries, as opposed to sports utility vehicles from Detroit automakers. India's Tata Motors is cashing in on the popularity of the Nano, and France's Renault plans to roll out a model with an Indian partner in 2012.

Meanwhile, what Hutchins called "the global gerontocracy" is providing both challenges for governments and opportunities for investors around the world. Every major country, with the exception of India, is growing older, he said, putting stress on social systems that support the elderly. China faces a particularly difficult challenge, because its one-child policy will require each worker to support two older retirees. Europe and Japan are aging as well, and the United States will have to count on immigration to bolster its younger labor force.

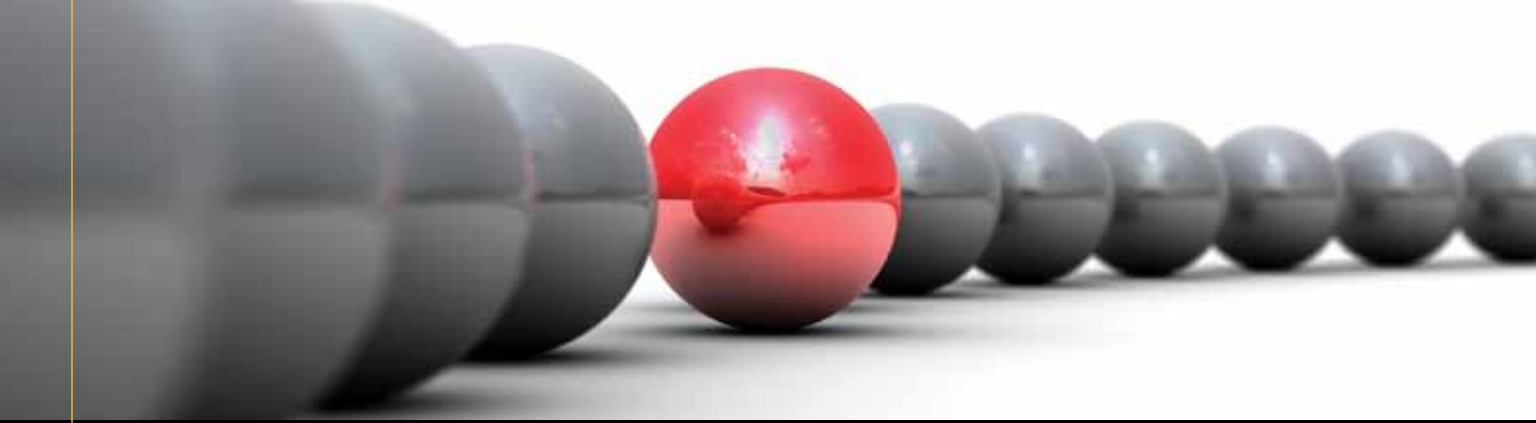
But "as the world gets older it consumes different things," Hutchins said. He pointed to the growing demand for health care as a target of opportunity for investors in the United States and elsewhere. For example, U.S. health care providers will need to accommodate 30 million new consumers with health insurance as a result of the reform bill that Congress passed last year. Aging populations and an emerging global middle class will strain resources that include energy, food and water, Hutchins added. This will create "massive

opportunities in investing in the efficiency and conservation of those resources," he said.

Technology will remain another staple for investment. Mobile technology "is the largest information technology trend of our lifetimes," said Hutchins, and the combination of wireless broadband and video will lead to a "vast explosion" in the demand for new products. He pointed to the Apple iPad, which enjoyed the fastest-selling consumer-electronics launch on record.

Hutchins compared the prospects for mobile technology to the rapid growth of personal computers, which arrived some 25 years ago. More than one billion PCs are now in use around the world, he noted. Meanwhile, the worldwide market for mobile phones and other hand-held devices is already five billion-strong and growing. As the makers of hardware and software for all the "gadgets and gizmos" that run on ever-expanding mobile networks innovate further, he added, investment opportunities will naturally follow. ☀





## As 'Megadeals' Lose Luster, Mid-sized Companies Are Becoming More Attractive

From 2003 to 2007, when credit was easily accessible, multibillion dollar “megadeals” were commonplace. But in the post-leveraged buyout (LBO) era, characterized by more conservatively capitalized transactions, private equity firms are increasingly focused on middle-market companies — or those with annual revenues of \$250 million to \$1 billion — with strong management teams and strategies, according to panelists at the 2011 Wharton Private Equity and Venture Capital Conference.

Middle-market investors have greater flexibility since they can exit through public offerings or by finding a strategic buyer to acquire their positions.

Companies that “are doing well in their niche, but lack the skills to expand into new areas” are particularly attractive, according to Craig Bondy, a principal at GTCR Golder Rauner in Chicago. Private equity firms that acquire such companies can then apply strategic guidance and operational expertise, Bondy noted during the panel titled, “Middle Market: Identifying and Creating Sustainable Competitive Advantages.” Moderating the discussion was G. Daniel O’Donnell, who chairs the private equity group at the law firm Dechert LLC in Philadelphia.

Tight money is encouraging the move toward

middle-market investing, said Michael Delaney, managing partner of Court Square Capital Partners in New York. With giant funds having trouble raising the cash for megadeals, “limited partners are gravitating to the middle market,” Delaney noted. Moreover, “There are a lot of questions in the limited-partner community about whether the mega-model [for funds] is viable,” he pointed out. “We will need to see how investments made in the late 2000s play out.”

Middle-market investors have greater flexibility when it comes to cashing out, Delaney added, since they can exit through public offerings or by finding a strategic buyer to acquire their positions. By contrast, a multibillion dollar private investment “might be performing well,” he noted, but the ability to exit from it “is tied to the general IPO markets.”

Private equity firms may have surprising exit routes, according to Benjamin Hochberg, partner at Lee Equity Partners in New York. He cited a specialty health care finance company that Lee funded in 2008 with \$500 million of debt capital. Lee has introduced the company, which lends to middle-market health-oriented concerns, to banks that might want to acquire a health care finance unit “when they are ready.” While Lee is not actively selling this business, Hochberg said, he is “pretty confident” of exiting successfully.

Hochberg agreed that the middle market offers more flexibility to private equity investors than the larger market, and has more room for entrepreneurial moves. “What distinguishes



the middle market is you can control your own destiny," he said. "In the middle market, somebody can write a billion-dollar check for something that was 'X' and is not yet 'Y,'" he noted, referring to a company's growth potential. "It's a little more fun than calling the equity capital desk [of a securities trading firm] to find out what the appetite is today in the public markets."

Meanwhile, deal flow will remain slow in the first half of 2011 but will pick up in the second half, predicted Andrew Steuerman, co-director of the direct lending group at New York-based Golub Capital, which finances middle-market companies. Steuerman said the ability to borrow at low interest rates creates healthy spreads for finance companies like Golub and helps to generate funds for private equity deals. "The supply-demand balance is good now," he noted, referring to the capital available for deals. "There is more competition. There aren't new competitors, but [public equity firms] are getting healthier."

### 'Green Roots Growing'

While fundraising will remain "very challenging" in 2011, the investing environment is nonetheless "getting pretty attractive," according to Sean Traynor, a member of the management committee at Welsh, Carson, Anderson & Stowe, a private equity firm in New York. "You're starting to see green roots growing, and some significant trees and leaves," Traynor said. "I think the overall economy, hopefully with the structural deficits improving, will continue to drive more confidence. Middle-market companies are well positioned to take advantage of that."

On the negative side, Traynor noted that the recession and the financial crisis have left pension- and endowment-fund managers fearful of not having enough cash on hand to meet capital calls, and thus reluctant to finance new deals. He added that few private equity firms have provided their limited partners with even 5% returns on deals made during the recent private equity boom, putting added pressure on fund managers to be selective in future investments.

Nonetheless, pension- and endowment-fund managers are currently under pressure to "stretch" into higher-yielding investments, Traynor noted, and private equity has historically

delivered such returns. But in order to get limited partners to reinvest, firms will have to demonstrate strong track records to "reinforce that there is a business strategy and a team and capabilities that warrant additional investments." Traynor expects competition for private equity funds to heat up as investors start putting money back into financial markets. But he doesn't look for the new dollars to drive up the valuation of private equity deals to "completely crazy levels."

While the next round of fundraising for Welsh, Carson, Anderson & Stowe is still more than three years away, Traynor said, some private equity firms are now in the fund-raising market. They include Providence Equity Partners, a large firm in Providence, R.I. "The reason many of these firms are successful is that they've had good returns and long-standing relations with limited partners," Traynor noted. "So I think that factor will be more important going forward."

Traynor, whose firm has no energy holdings at present, pointed to the energy sector when moderator O'Donnell asked the panel to name industries that looked well-positioned for private equity investment. "If I had money and was starting a fund, energy is an area that has such tremendous wind at its back," said Traynor. "That wind will be blowing now, and for all of our lives and then some," he noted, thanks to the "increasing demands of emerging markets and, hopefully, a developing middle class around the world."

Hochberg cited global trade as his top pick for investment. He said Lee Equity is looking for businesses that build supply chains between the United States and consumers and businesses around the world. For example, he suggested third-party logistics companies that provide transport, warehousing and other services for moving goods from country to country. "The consumer is no longer just in Cleveland," said Hochberg. "We need to move products out."

For Delaney, cyclical industries that were hard hit in the recession could be attractive investments. Cyclical industries typically include sectors such as construction and durable goods. While cyclical industries may not be poised to boom, Delaney noted, they are climbing out of a downturn so

deep that future returns will be strong.

General partners will begin to invest once cyclical companies begin to show solid sales growth, Delaney said. “Over the last 30 years, we’ve all made a killing in cyclical businesses coming out of downturns,” he noted. “Whether this cycle is cooperative, given the excess capacity out there, I don’t know,” he added. “But we are at the start [of] when cyclicals become more attractive.”

Changes in software licensing make the software sector attractive as well, according to Bondy of GTCR Golder Rauner. The industry formerly used what Bondy called a “lumpy” licensing model that led to irregular revenue flows. But with software now widely available to users from

central — or “cloud-based” — sources, revenue is steadier and lenders have become more interested in financing software deals, he said.

Steuerman took what he called the “easy lay-up” by choosing health care as the top investment opportunity, despite uncertainty about the fate, and final design, of U.S. health care reform. Health care now accounts for 17% of the U.S. economy, Steuerman said, and is likely to grow to 20%. “The market is too big, even with the regulatory overhang, not to go after it,” he noted. ☀





## Where Markets Are Hot: Opportunities for Venture Capitalists Across the Globe

From China and India to Southeast Europe and Latin America, the rise of huge young populations of middle class consumers is creating rich opportunities for private equity and venture capital investors. Top targets for investment in these emerging markets include companies in the Internet, financial services and clean technology sectors.

These were among the key points of venture capital panelists, many of whom are currently working in developing countries, at the 2011 Wharton Private Equity and Venture Capital Conference. Participants on a panel titled “Challenges and Opportunities for Global Venture Capital” addressed the developing areas of China, India, Southeast Europe, Turkey and Latin America during the session, which was moderated by Jeanne Metzger, director of marketing for the National Venture Capital Association in Washington, D.C.

### China: A Booming Market

The Internet sector is particularly attractive in China’s vast and rapidly growing market, said Andras Forgacs, managing director of Richmond Global, a New York City-based venture capital firm that focuses on technology. Forgacs noted that Richmond Global looks for companies with business models that are similar to those that the firm has already backed in the United States. For example, Richmond Global has a position in AdChina, an Internet advertising company that is similar to aQuantive in Seattle, Washington. Richmond Global provided seed money to aQuantive, which Microsoft acquired in 2007.

According to Forgacs, the biggest mistake U.S. companies make when investing in China is not having their own managers on-site in the country. Companies too often oversee their investments from outside China, he said, and are thus slow to react to changes in the market. This can give local entrepreneurs a competitive advantage.

China’s booming economy puts skilled workers in high demand and makes retaining talent difficult, Forgacs added. Experienced programmers and engineers can easily hop from one employer to another in Shanghai and Beijing, for example, while other workers may start their own companies. Competition for employees also comes from well-educated Chinese business people who return to their country from abroad and start new companies.

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Top targets for investment in emerging markets include companies in the Internet, financial services and clean technology sectors.

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Richmond Global is currently looking at opportunities in smaller and less frenetic Chinese business hubs like Chengdu. “There are some interesting investment opportunities where there is less competition and more patient development of companies and talent,” Forgacs said. He added that China’s strong public markets give investors confidence that they will be able to liquidate their positions. But exits through mergers and

acquisitions are less common, Forgacs noted, because Chinese business people are extremely value-conscious and drive a hard bargain.

## Clean Tech in India

Clean technologies are a prime source of opportunity in India, said Mohanjit Jolly, managing director of Draper Fisher Jurvetson in Menlo Park, California. Such technologies include renewable resources, recycling and pollution-control equipment. Like China, India has a fast-growing economy with a huge emerging base of consumers. Conversations around Indian water coolers are not about whether investments will earn returns, said Jolly, but rather about how large the returns will be. "It's an incredible time to be in India and part of the ecosystem," he said.

Retaining talented workers is difficult in India, said Jolly, since employees are typically willing to jump to companies that offer even slightly higher pay. Jolly hopes to set up a vesting plan for employees of Draper Fisher's portfolio companies that rewards them with growing amounts of equity the longer they stay. However, India remains a cash-based economy when it comes to compensation, Jolly noted. "That's the reality. How it morphs remains to be seen."

Like China, India has robust public markets that attract capital to young companies and provide profitable exits for investors. Local groups of angel investors also are forming to invest in early-stage companies and fill a long-standing gap in seed capital. Jolly said venture capital funds are using these groups as a "fertile deal flow mechanism" by getting to know them and using them as leads to good companies.

## Southeast Europe and Turkey

Financial services provide the most exciting opportunities for investment in Southeast Europe and Turkey, said Denis Kalenja, founder and managing partner of Montague Capital Partners, which has offices in New York City and Research Triangle Park in North Carolina. Commercial banking has performed well in the region, which Kalenja said still needs more financial services such as asset management firms. He added that distressed real estate, including beachfront property on the Adriatic coast of Croatia, could provide a good opportunity for investors who are

familiar with the area.

Southeast Europe remains a fragmented market made up of many small countries with populations that speak different languages, Kalenja noted. The region's industries thus have a critical need to consolidate to build economies of scale and generate value for investors. But in the boom years before the global financial crash, local executives thought they could build companies on their own without partnering across borders, he added. Now executives are more willing to consider mergers. "The people in this region realized they cannot do it themselves. Finally, the region is ripe for investing and consolidation."

Venture capitalists who come to Southeast Europe can easily find three or four families or entrepreneurs that dominate particular industries, he said. This can provide a starting point for entering the market with investments that help businesses consolidate.

Investors based in Western Europe are increasingly looking toward the southeast for higher returns, Kalenja noted. But such investors often lack experience in local markets. Meanwhile, many of the most talented and highly educated businesspeople in Southeast Europe and Turkey are moving in the opposite direction by relocating to larger markets in Western Europe and North America. This leaves fewer native-born entrepreneurs who are willing to stay in the region or return from abroad to launch new companies.

## Latin America: Focus on Sustainability

Attractive venture opportunities in Latin America include investments in companies that provide clean energy, water, natural gas and sustainable agriculture, said Benjamin Sessions, managing director of the Global Environment Fund in Chevy Chase, Maryland. Latin America is only now embarking on the process of curbing pollution that the United States went through in the 1960s and 1970s, Sessions noted. This is crucial for the region, since its economic growth has not been "matched by the environmental infrastructure and services needed to sustain that growth."

Talented Latin American workers typically prefer cash to equity compensation, he added, which can strain the resources of early-stage

companies. Workers “value cash in their pocket,” said Sessions. “Giving options or ownership does not necessarily have the desired impact.” But this appears to be gradually changing, he noted, as successful public offerings show that equity stakes can grow in value.

Other opportunities in Latin America come from the service and manufacturing sectors, said Roberto Woldenberg, managing partner of Indigo Capital in New York City. “We are very excited about the area,” said Woldenberg, who focuses on Mexico, Central America and Bolivia. “There are some challenges in social, economic and political issues, but by and large we see a lot of bright spots.”

Latin American economies may not be growing at the same spectacular rate as China and India, Woldenberg noted, but the economies nonetheless “have their act together in fundamental ways.” Countries in the region are characterized by youthful labor forces and low levels of debt, he said. “Compared to the West, they have the potential for growth.... The venture capital industry in this part of the world is in a very incipient stage.”

## Avoiding Corrupt Practices

Panelists turned to the U.S. Foreign Corrupt Practices Act (FPCA) when moderator Metzger asked about its impact on their firms. The measure bars U.S. individuals and corporations from making payments to foreign governments in return for business. Woldenberg said his firm conducts careful audits and accepts that “unfortunately, there are businesses you have to

pass on. On the other hand,” he added, “I will say that in Latin America, while there are pockets of corruption, by and large most people want to do their job and they want to do it well.”

Sessions noted that while U.S. investors can take careful steps to avoid running afoul of the FPCA, “it all boils down to who you are investing with and what values they put in their network.” The Global Environment Fund avoids bidding for business through auctions, he added, since the process makes it hard to get to know the managers who will run the acquired companies.

Jolly said his firm conducts a rigorous audit before and after investments in India to make sure there are no violations of the FPCA that could lead to criminal convictions and jail time. “We simply cannot afford, directly or indirectly, to be seen as condoning [improper] behavior.”

In Southeast Europe, businesses regard the FPCA as something of a relief, said Kalenja, since government officials know they cannot solicit bribes from U.S.-connected companies. In fact, “we observe people coming to us and asking for an investment to acquire immunity,” he noted.

Forgacs said his firm initially invests small amounts of money in Chinese companies and gradually raises its stake as it grows more comfortable with its partners. Forgacs keeps a desk at the portfolio companies and spends time getting to know the comptroller and chief financial officer. “I talk to people in the trenches,” he said. “You have to be in the company cafeteria so nothing surprises you.” ☀





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## Let's Make a Deal: Distressed Companies Appear Ready to Turn to Private Equity

The global financial crisis has created a backlog of distressed companies that are gradually becoming ripe for private equity investments. That was a key message of speakers on a panel titled, "Distressed Investing: Identifying Opportunities and Realizing Value in Recovering Markets," during the 2011 Wharton Private Equity and Venture Capital Conference.

Panelists agreed that many troubled companies and their lenders were still using a strategy of "delay and pray" for better times, which has kept the firms off the market. But speakers said the strategy is likely to fade as beleaguered companies turn to private equity investors for sorely needed funds. This will create a wealth of fresh opportunities for firms that specialize in turning around troubled assets, according to members of the panel, which was moderated by Michael Ranson, a partner in Blue Wolf Capital in New York.

Ranson kicked off the session by asking the five panelists how the current economic cycle was affecting private equity deals and how the cycle will likely play out. "We're kind of taking a pause," noted Harvey Tepner, senior managing director of WL Ross & Co., a turnaround firm in New York. Tepner said deal-making slowed sharply in 2009, but should make a strong comeback when the growing federal deficit drives up inflation and the corresponding rise in interest rates triggers defaults by troubled companies.

This will force borrowers that have been able to sustain operations in a period of low interest rates to restructure or sell out, Tepner stated. "Companies that have depended on 'delay and

pray' will have their day of reckoning when they need to refinance debt," he said. While he couldn't say just when that day might occur, he predicted that it would be before the 2012 presidential election.

For now, Tepner said, his firm is looking for opportunities in real estate, banking and financial services. Health care companies could be another target of opportunity, he added, in the wake of the new health care reform law.

### Banks Refuse to Call Loans

Gregory Segal, managing partner at Versa Capital Management in Philadelphia, focused on the unwillingness of banks to force troubled companies to meet their loan obligations. Calling the loans would require the banks to acknowledge that many of the assets on their books are actually in default, Segal said. Consequently, the banks and the companies are collaborating in a policy that he described as "amend, extend and pretend" with regard to bad loans.

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Many troubled companies and their lenders are still using a strategy of "delay and pray" for better times, which has kept the firms off the market.

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This contrasts with the tough-minded policies that banks pursued before the financial crisis, according to Segal. Back then, nearly all of the firms that Versa invested in had a "bank with a gun

to someone's head" that forced the companies to sell or liquidate, he said. "Those people have disappeared for the most part in the past two years," he noted, referring to such companies.

Segal now spots signs that point to more normalized deal volume. Some companies that might have amended their loan agreements six or seven times no longer see much point in further amendments, for example, and are open to taking in partners instead. Even companies that appear healthy from an income standpoint may be aware that their "leverage is intolerable and still unresolved," Segal said.

Target companies pass through life cycles that resemble a U-shaped graph, Segal noted. They slump on the left side of the "U" and recover on the right. Versa invests when companies are at the lower part of the "U." The firm typically buys debt on the left side of this cycle and prefers equity if the company is moving up on the right.

Segal added that economic conditions are now changing at "breathtaking speed," citing the surge in cotton prices that could dramatically affect an apparel chain that Versa owns. "Distress is tied to the human condition," he noted. "People make mistakes. They have bad strategies, or they execute poorly, or they get their hand caught in the cookie jar. Those are steady flows of deals. But if you are a player in our space, the number of variables and the volatility in commodities and the economic cycle is overwhelming." This creates a level of distress that Segal said he has not seen in 20 years.

Other panelists pointed to growing investment opportunities in the real estate industry, which started the financial collapse and remains a drag on the economy. Colorado-based Real Capital Solutions expects to acquire \$200 to \$300 million of distressed real estate assets this year, according to founder and CEO Marcel Arsenault, who noted that the industry has always been highly cyclical.

## A 'Great Flushing Sound'

Eventually, the "blue light" signaling rock-bottom prices will go on, said Arsenault, and this will be followed by a "great flushing sound, which is going to be an opportunity of a lifetime" for real estate investors.

While the industry could face another two to four years of "extreme pain," he added, "It will be sunny again." Large real estate investment trusts already have made major investments in high-profile assets, he noted. "That bus has left," he said. "But if you get out to Main Street and start looking at strip centers and office buildings in Peoria you're going to find plenty" of attractive investments.

Panelists noted that the current economic cycle calls for a variety of investment approaches. Marc Baliotti, managing director at GSO Capital Partners in New York, described his firm's successful experience in the auto and light truck market. GSO Capital aggressively bought out a company's lenders at a sharp discount when the industry was reeling in 2006 and is now poised to benefit from a turnaround in the automotive sector.

On the other hand, GSO holds a stake in a Midwestern drive-through fast-food chain that has not yet recovered from the recession. "People are not driving through the window" because unemployment is in the high teens in the area, said Baliotti. "In that business, we are very defensively focused," he noted, since GSO is managing the investment without taking new risks.

The fast-food business entered the recession about nine months after the automotive company and will probably exit nine months later, Baliotti predicted. "We try to time when particular markets will come back, and how strong the comeback will be, and position our capital accordingly."

What most worries Baliotti about the current economy is that unemployment has remained stubbornly high. "We're 18 months out and unemployment has really not declined, and that's not been the case in previous recessions," he said. "There's a real case to be made that there is structural unemployment." On the bright side, he added, the uncertainty about job security that the 90% of the workforce that is employed has experienced is beginning to clear, which should help to boost the recovery. "That second big flush [of investment opportunities] is coming," he noted, "we're just not sure when it will happen."

## Cleaning Up Portfolios

Maureen Downey, a principal at Pantheon Ventures in San Francisco, said the firm plans to increase its stake in distressed companies to between 20% and 30% of its portfolio over



the next three to five years, up from about 15% five years ago. Downey expects a number of distressed companies to come on the market this year and next as pension funds and institutions that hold endowments retrench. "There is just an overarching need for institutions to clean up their portfolios," she noted.

Downey specializes in secondary offerings and said the financial sector looks particularly attractive for such deals. Buyers of secondary offerings purchase their stakes from initial investors in private equity funds. Many current investors are now expected to exit the financial sector in response to the "Volcker rule" section of the new Dodd-Frank financial reform law, which limits activities by banks and financial institutions. Downey also looks for the "vast quantity" of private equity funds that were raised between 2005 and 2008 to begin to turn over as limited partners seek exits, "and that's a great deal of volume for us in the next three to five years."

Downey pointed to poor performers in the U.S. consumer Internet, health care services and software industries when moderator Ranson asked which sectors were likely to provide the

best opportunities for distressed investing. Opportunities are also opening up in Europe, she said, as governments put public assets on the market to reduce debt. "Finally, I don't think you can overlook the emerging countries," Downey said. "We are an intertwined, global economy. There will be cycles in commodities, and you can't overlook interest rates and currencies, but there is tremendous growth in the global middle class."

Segal noted that Versa Capital does little prospecting and typically waits for deals to flow into the firm as if it were "an emergency room." But he said the health care industry could become a source of distressed assets because of uncertainties surrounding the health care reform law, including its ability to survive legal challenges. "Uncertainty is great for my business," he said. "When things are volatile, people get panicky and they make the wrong decision. They pull the trigger too soon or too late."

He added that Versa's own portfolio companies seem to be turning around. "Demand is coming back stronger," he said. "I think we may have underestimated the recovery, just like we underestimated the decline." ✨



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