



**EFFECT OF THE RECESSION ON
PRIVATE EQUITY AND LEVERAGED
BUY-OUTS (LBOS): BURNED, BUT THE
PHOENIX IS RISING FROM THE ASHES**

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Introduction

The Greatest Recession which commenced in 2007, picked up steam in 2008, ran into high gear in 2009, and is still lingering in 2010, has had a material adverse effect (MAE) on private equity and leveraged buy-outs (LBOs). During this period, private equity and mergers and acquisitions have had to withstand a trying twelve-round boxing match akin to the Ali-Frazier Thrilla in Manila fight against the likes of panic in the markets, frozen credit markets worldwide, substantially reduced fundraising, deal inertia and flight, difficulty in exiting investments, deteriorating global stock markets, and severe slowdowns in the debt, equity and initial public offering (IPO) marketplaces. The year 2009 was one of the worst years in the history of private equity and LBOs. For example, in the fourth quarter of 2009, fundraising for private equity funds was at its worst since 2004. Although mergers and acquisitions transactions were somewhat better in this quarterly period, we are witnessing a strange transformation in the private equity and LBO marketplace. The days of the prowess of the mega funds (multi-billion dollar funds) and easy acquisition debt have moved to the immediate sidelines and the small cap and mid cap private equity funds have taken center stage. There is an underlying belief in the marketplace that we will not soon cycle back to the days of years like 2006 and 2007 when mega funds and deal mania were kings. The banks are now very cautious in lending into LBOs and the equity going into deals is in the forty percent (40%) range. Given what has happened during the Greatest Recession, we may think we are doing private equity and LBO transactions reciting the jabberwocky poetry of Lewis Carroll's Alice In Wonderland.

Has the Greatest Recession caused third degree burns to private equity and LBOs that will not heal? Is the landscape too charred for regrowth? The answer to these two questions is no. Private equity and LBOs have battled the Greatest Recession, come out a little beat up, but have healed and are in the midst of a cautious comeback.

Prelude to a Collapse and the Greatest Recession Gains Strength: Private Equity and LBOs Falter

In June 2007 two Bear Stearns hedge funds -- High-Grade Structured Credit Strategies Enhanced Leverage Fund and the High Grade Structured Credit Strategies Fund -- which had been set up ten months earlier and mainly invested in subprime mortgages, collapsed and their assets were seized by Merrill Lynch. This was the start of the public collapse of the mortgage-backed securities market, although the mortgage-backed market had experienced losses in 2006. Subsequently, Bear Stearns collapsed and was sold in a fire sale in March 2008 to JPMorgan Chase. On September 15, 2008, Lehman Brothers filed for Chapter 11 bankruptcy protection (after selling only certain assets to Barclays) and during this month American International Group (AIG) was bailed out by the U.S. Government with an \$85 billion credit facility.

Many of the large U.S. commercial banks -- such as Citibank, Bank of America, Key Corp, Capital One and numerous others -- experienced severe balance sheet problems as a result of the mortgage-backed crisis and worldwide credit crisis and sought and obtained U.S. government assistance. A global credit and banking crisis was taking place at banks around the world.

Some feared that we had entered the Second Great Depression, but a severe recession was gripping the world as professionals and market participants fretted as to what would happen to private equity and LBOs.

All of the above factors had a profound negative effect on the private equity industry and LBOs. The years 2006 and 2007 and a good deal of 2008 had been very robust for private equity, mergers and acquisitions and LBOs -- this period represented one of the best times in the industry. But this would change dramatically.

The calamity in the markets was accompanied by the Greatest Recession. This had severe repercussions around the world, especially in the United States. The stock market during 2008 and 2009 witnessed massive losses; during 2009, for example, the Dow Jones Industrial Average (DJIA) started the year at 9,034, dipped to 6,547 on March 9, 2009 and moved up to 10,428 on December 31, 2009. Unemployment in the United States during 2009 moved into the high nine percent range.

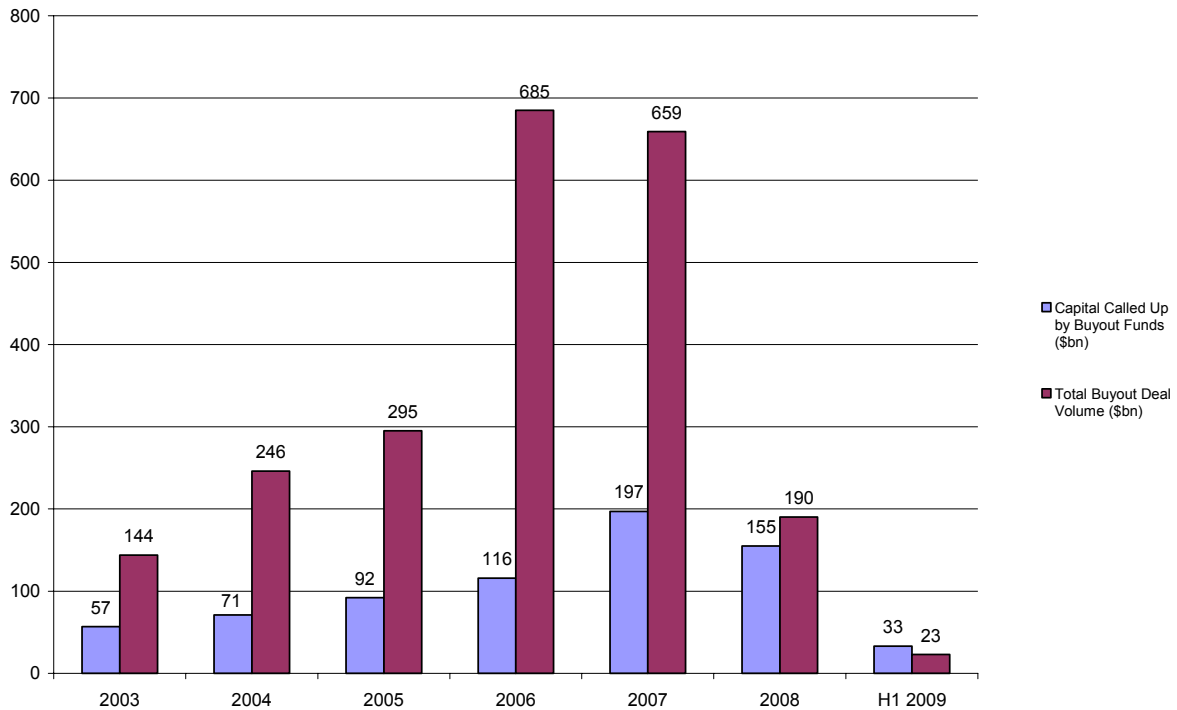
The beneficial conditions for private equity and LBOs deteriorated rapidly in 2008 and 2009. High leverage multiples and covenant lite loans were few and far between. Higher equity requirements and more stringent lending terms and debt covenants were now in force. Fundraising and deals slowed to a crawl.

Against the backdrop of these events private equity could not continue at the same pace. 2009 would represent a distressing turning point for private equity and LBOs. Deal volume and private equity fundraising collapsed; a great number of private equity funds closed. The weight of the recession, global credit crisis and stock market collapse, investors seeking safer asset classes and decline in the values of funds' portfolios, were too much for the industry to hold up against. The value for private equity deals in 2009 was \$77 billion, a 61% reduction from 2008 (\$190 billion), and 88% down from 2007 (\$659 billion). The number of LBO deals has also declined: 2009 - 925; 2008 - 1,846, and 2007 - 2,556. Source: Preqin.

LBO Activity

The chart below shows the amount of capital called up by private equity firms and total deal volume by year from 2003 - 2009 (first half). Note the substantial decline in activity during 2008 and the first half of 2009:

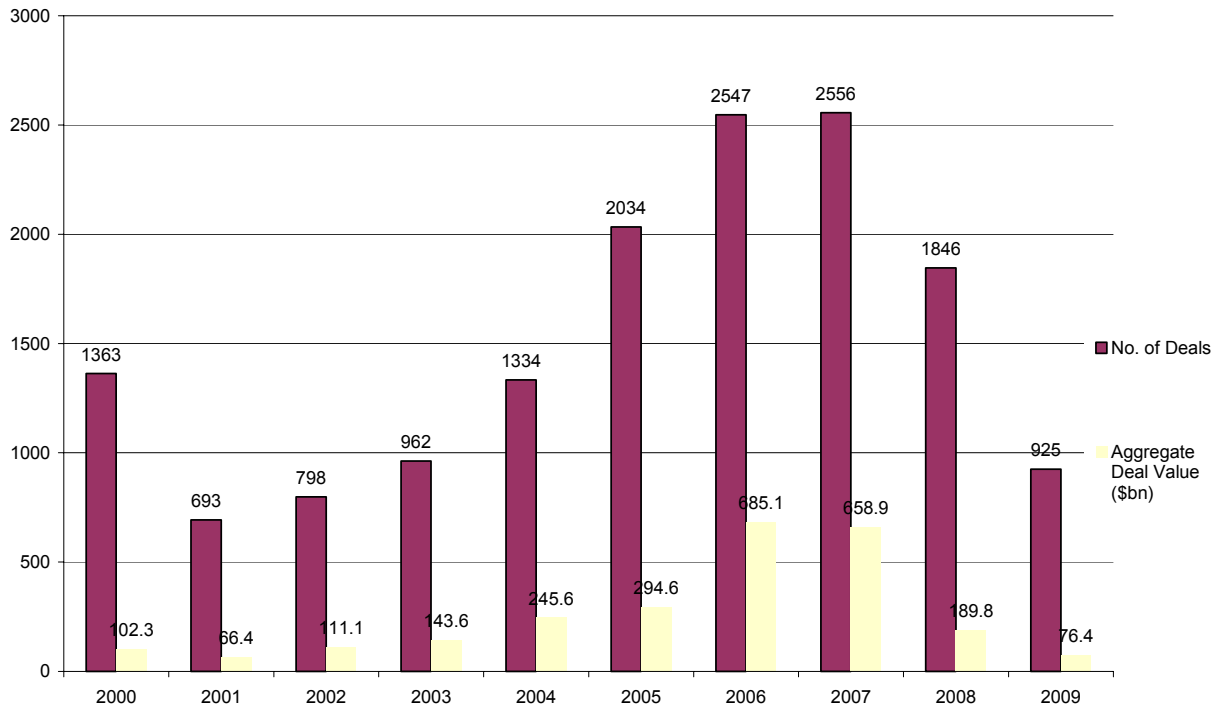
Annual Global Buyout Firm Capital Called Up and Global Buyout Deal Volume



Source: Dealogic/Preqin

The next chart shows the number and value of deals by year from 2000 to 2009. Note the buyout strength during the years 2005, 2006 and 2007, followed by a significant decline for the years 2008 and 2009.

Number and Value of Deals* by Year 2000-2009

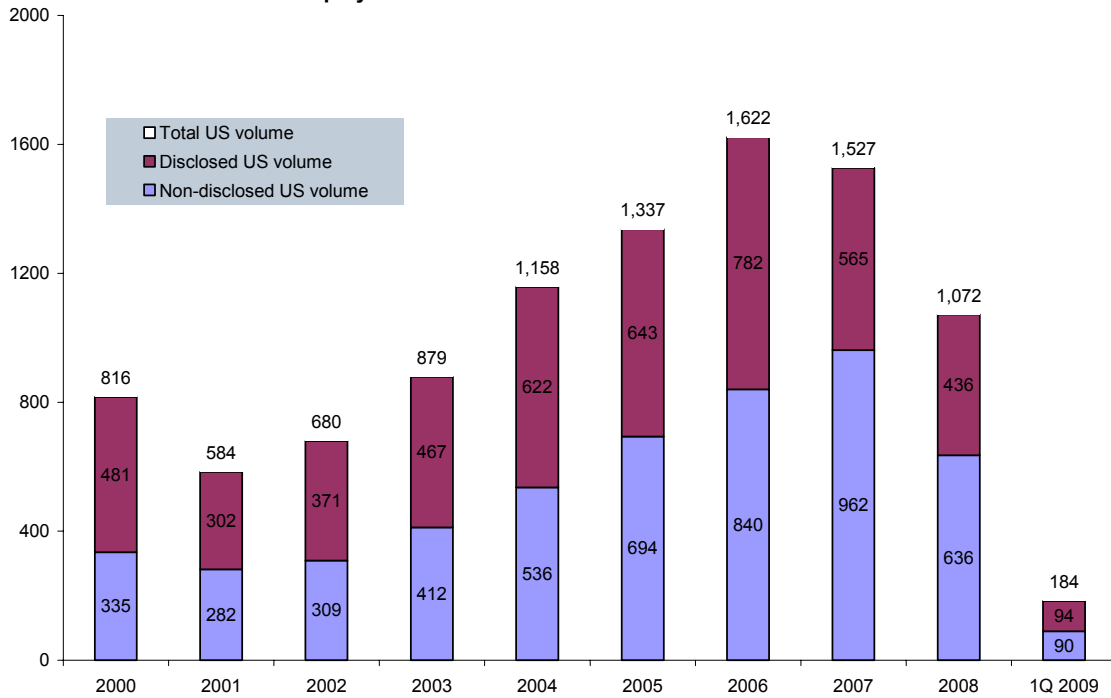


*All data excludes add-on deals

Source: Dealogic/Preqin

The charts below show announced United States private equity deal volume and announced United States private equity deal value from 2000 to 2009 (first quarter). Again, the decline in 2008 and 2009, particularly in deal value, is substantial.

Announced US Private Equity Deal Volume

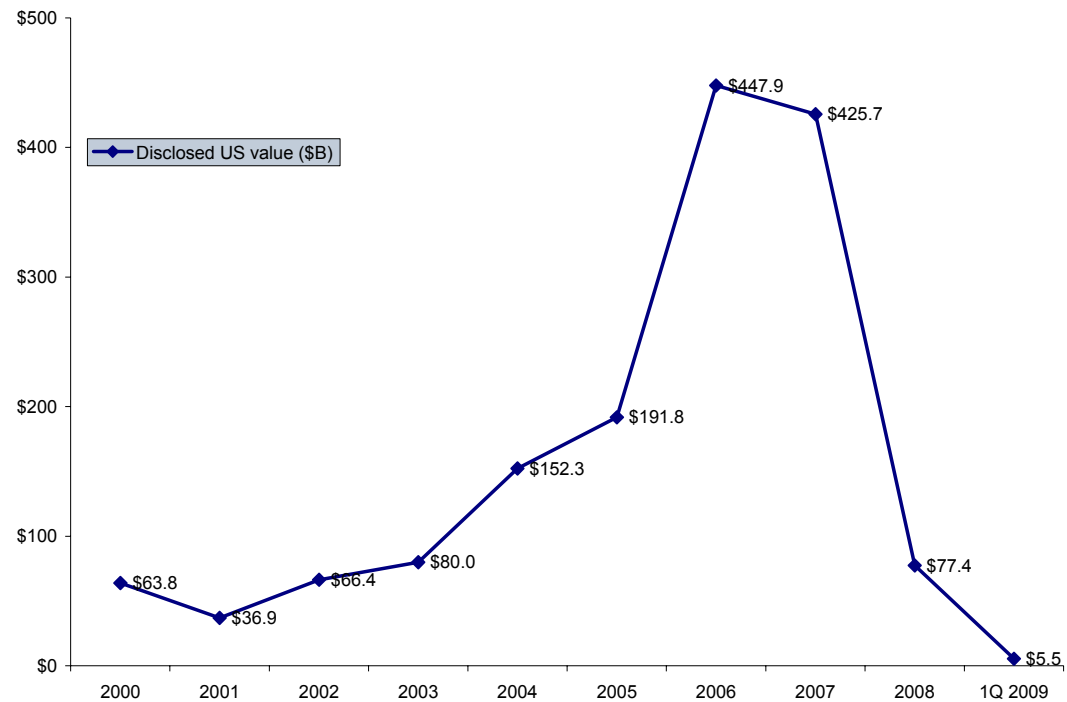


Source Dealogic

This chart captures transactions where the buyer is a US or foreign private equity firm acquiring a US based target

Announced US private equity deal value

\$ in billions



Source: Dealogic

This chart captures transactions where the buyer is a US or foreign private equity firm acquiring US-based targets

The chart below shows for the years 1998 to 2009 all announced merger and acquisition activity broken into two categories: (a) strategic mergers and acquisitions; and (b) buyouts.

Note the 2008 and 2009 declines.

Announced U.S. M&A activity				
	Strategic M&A		LBO	
	\$(bn)	#	\$(bn)	#
1998	1,428.67	10,623	33.93	278
1999	1,447.09	9,812	58.81	461
2000	1,414.87	9,437	43.89	524
2001	723.70	7,369	18.91	257
2002	383.55	6,505	48.57	377
2003	459.83	6,269	56.33	444
2004	651.28	6,727	109.03	616
2005	913.38	6,510	132.06	843
2006	1,027.46	8,224	397.01	1,088
2007	1,022.51	8,642	377.15	1,020
2008	872.21	7,286	61.82	710
2009 YTD	417.26	3,939	14.47	341
Sources: Dealogic				

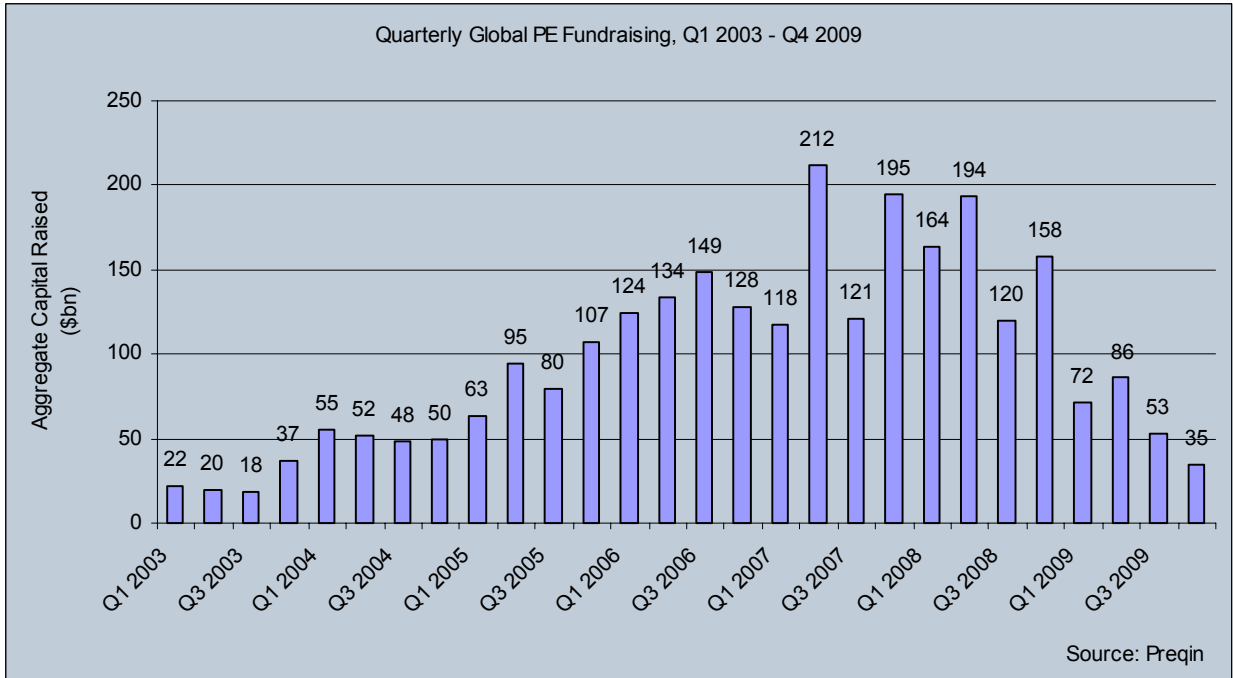
This chart illustrates that United States LBO activity declined from \$377 billion (value) in 2007 to \$62 billion (value) in 2008 and \$14 million (value) in the first nine months of 2009.

These declines are staggering when you examine how far United States LBO activity fell in 2008 and 2009 from the high levels in 2006 and 2007. One is reminded of the fall off in LBO activity in 2001 and 2002 after the dot-com bust of 2000-2001 although this decline was not as severe. The strategic mergers and acquisitions and LBO markets rebounded a few years after the dot-com bust, but it was a slow recovery.

Private Equity Fundraising

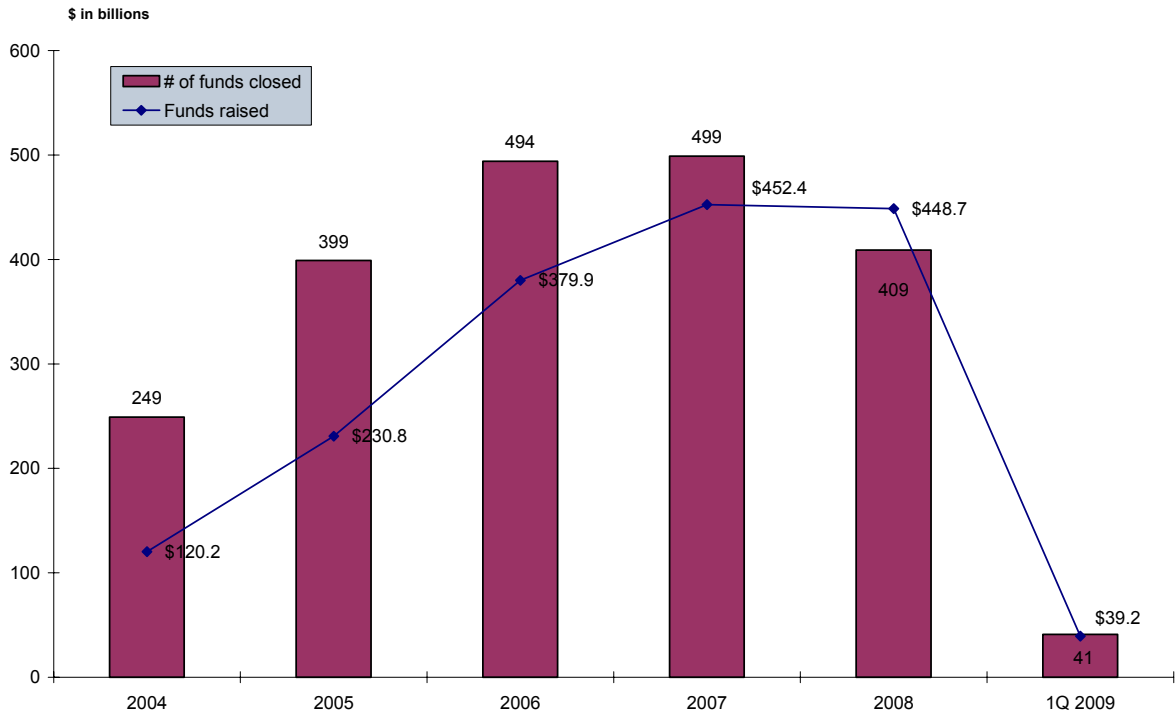
The Greatest Recession has wreaked havoc on private equity fundraising. During 2009 private equity fundraising experienced severe declines.

The chart below shows quarterly global private equity fundraising from the first quarter of 2003 to the fourth quarter of 2009. Note the fourth quarter of 2009 when only \$35 billion was raised. You have to go back to the third quarter of 2003 to find a lower number (\$18 billion). Also note the high in the second quarter of 2007 when \$212 billion was raised.



The chart below shows global private equity fundraising by number of funds closed and funds raised for 2004 to 2009 (first quarter). Note the dramatic fall off for 2009.

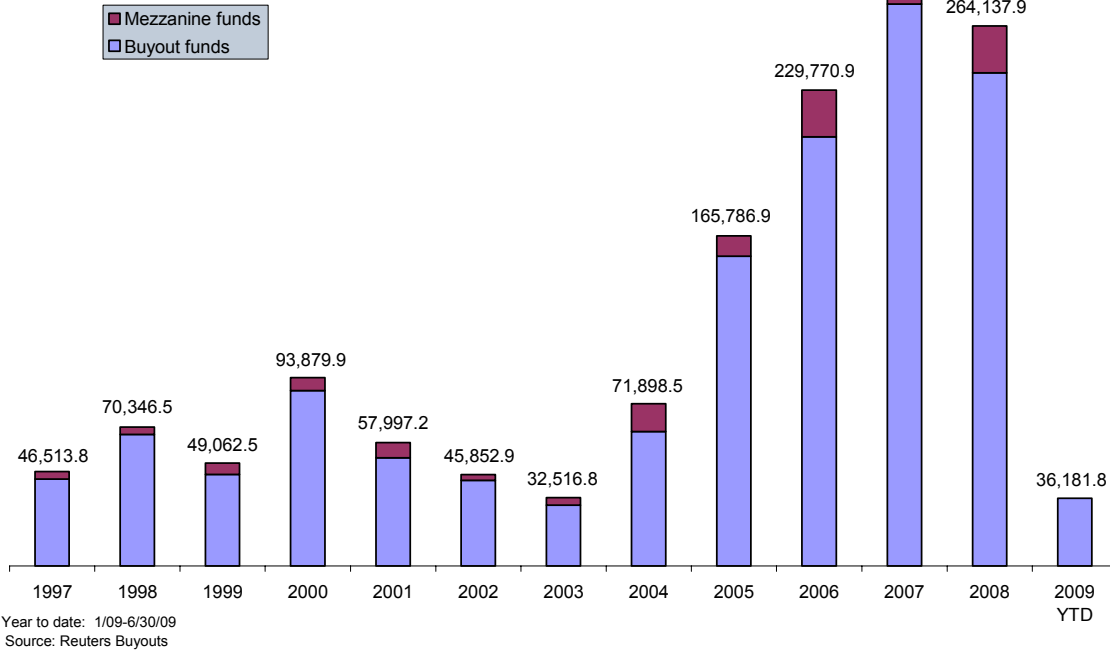
Global fundraising efforts



Source: Preqin

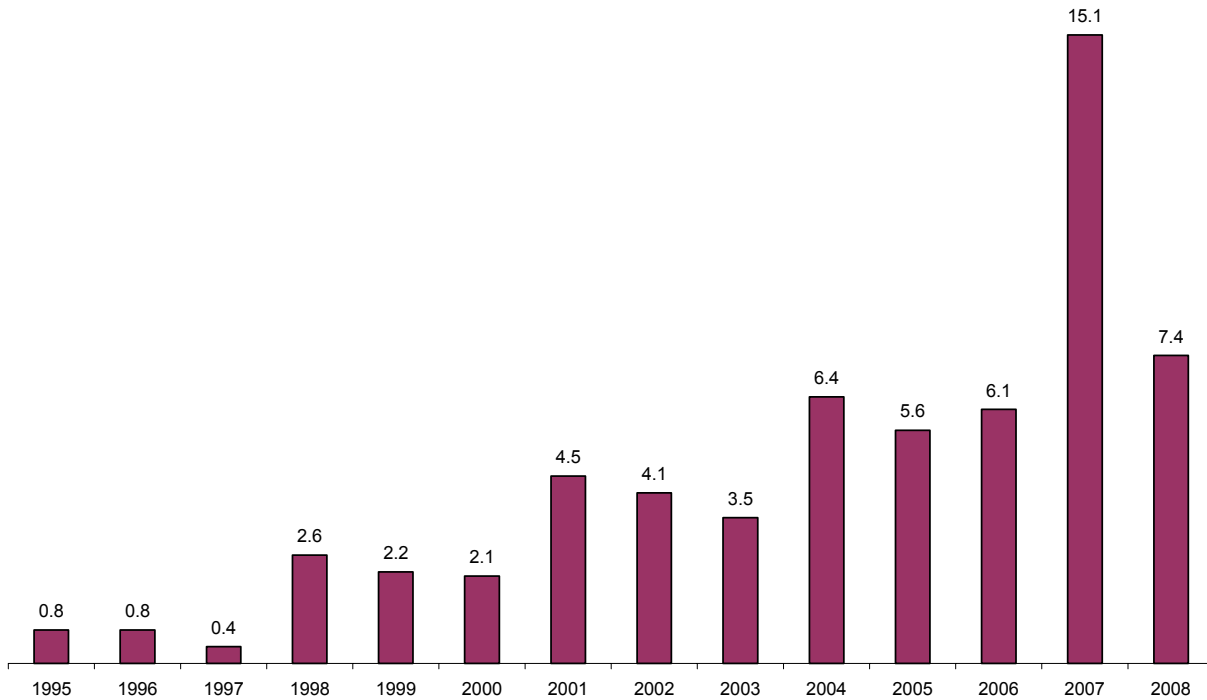
The chart below shows total United States buyout and mezzanine fundraising for 1997 to 2009 (first six months). Again, the decline in 2009 is apparent.

Figure 12
U.S. buyout and mezzanine fundraising
 (\$M)



Secondary funds raising equity capital also suffered during the Greatest Recession. See the chart below.

Capital raised by secondary funds (\$B)

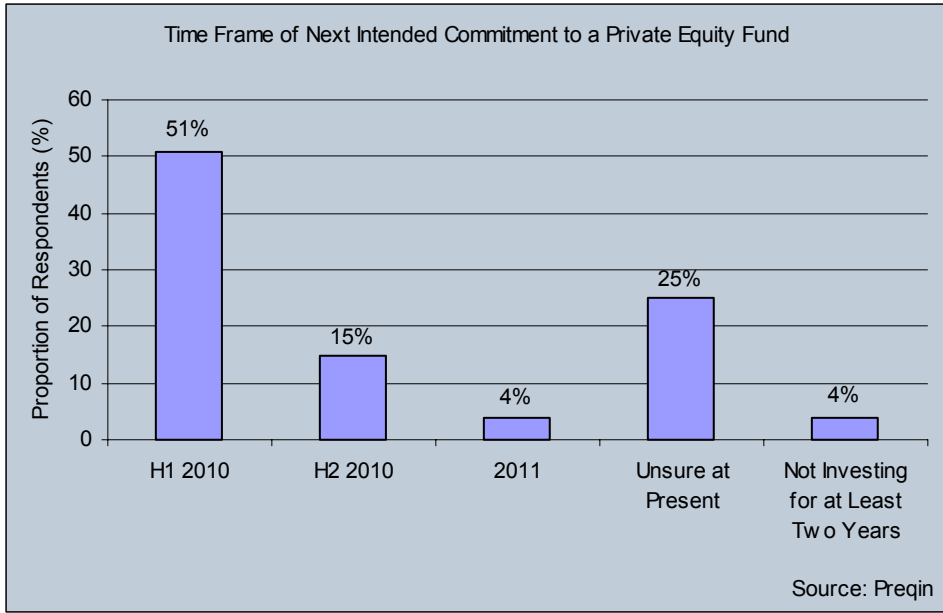


Source: Probitas Partners

2010: Rebound, Change and Cautious Optimism in Private Equity and LBOs

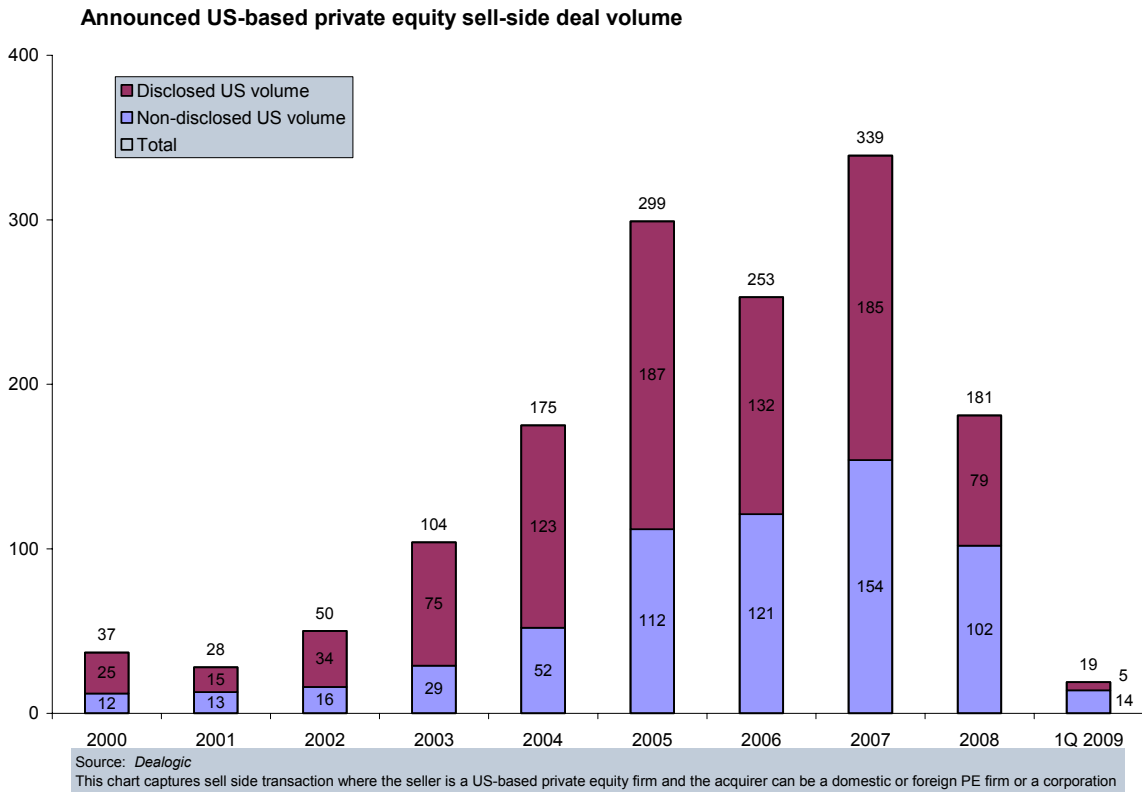
The outlook for 2010 for private equity and LBOs looks promising but should be characterized as cautious optimism. The level of private equity fundraising commitments are improving. Investors have indicated that they will allocate more funds to private equity. Smaller and mid-size private equity funds remain in the spotlight, although this could change as mega deals are picking back up which need mega funds. Mergers and acquisitions activity is also picking up along a broad range of transactions, but not back to any prior frothy levels.

The fundraising activities of private equity funds is intense. Investors are interested, but cautious. The chart below shows this. Note twenty-five percent (25%) of respondents being "unsure at present" with respect to their next commitment to a private equity fund.



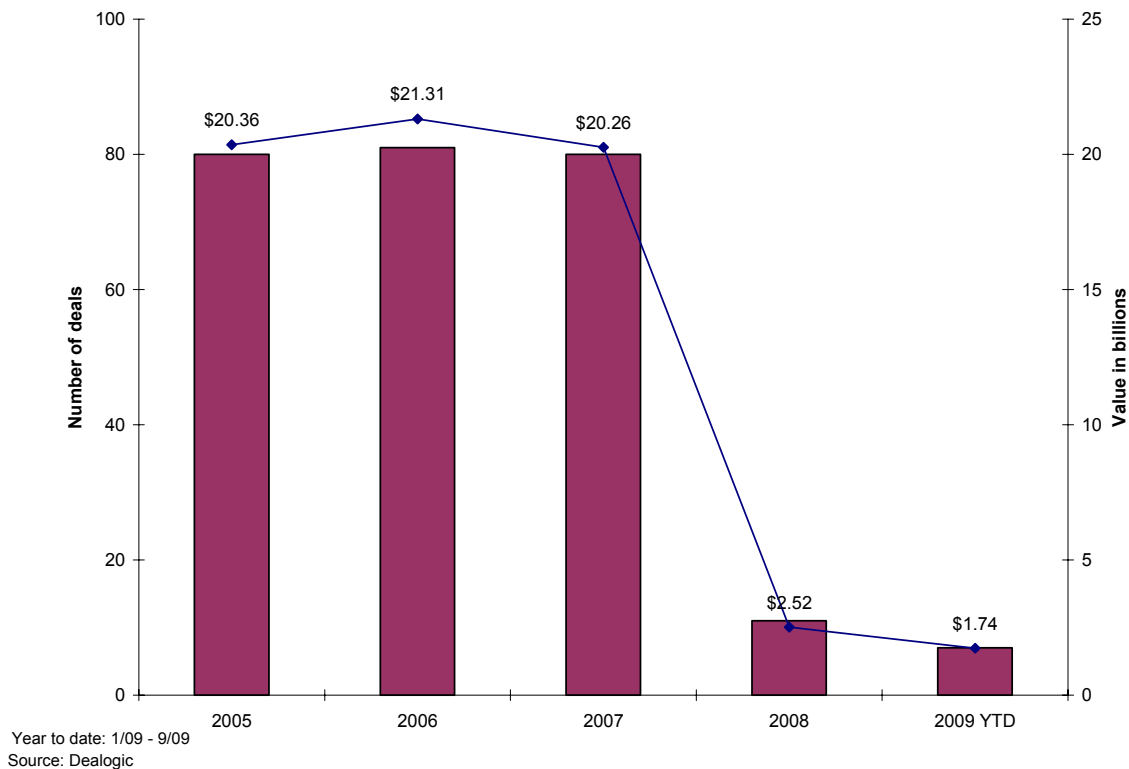
Investors pondering going into private equity funds are concerned with exit opportunities.

This issue is illustrated in the graph below.



Also, as the chart below indicates, exit by IPO has been very difficult in the past two years but will undoubtedly improve in 2010:

U.S. financial sponsor-backed IPOs (\$B)



The highlights for 2010 for private equity and LBOs are:

- Investors gradually returning to market. Amount of capital and number of investors will increase over historically low 2009 levels.
- Investors most interested in distressed private equity funds in the small and mid-size level. Belief that investments made by these funds during stages of recession could bring healthy returns.
- Private equity fund terms are changing and becoming more friendly to investors. Investors usually will not invest in a fund if they do not like the fund's terms and

conditions. Frequent areas of negotiation and change are management fees, carry structure, clawback, rebates and compensation.

- Investors are conducting more due diligence, and scrutinizing transactions, portfolios and the history of the fund.
- Estimates are that private equity funds have \$500 billion in deployable capital or "dry powder."
- Mergers and acquisitions deal flow is picking up in the first quarter of 2010, although the banks are extremely cautious in lending into a transaction and are demanding high equity requirements (can be in the forty percent (40%) range). This is a problem faced globally. The recent banking, currency and fiscal crises in Greece, Spain and Portugal do not help. Fund managers are facing difficulty restructuring financing for existing portfolio investments.
- Sellers again seem interested in selling and closing.
- Pace of private equity backed IPOs should increase. Leveraged distributions will stay very quiet.

The Greatest Recession dealt a powerful blow to private equity, LBOs and mergers and acquisition transactions. But this business is very cyclical and seems poised for a healthy rebound in 2010. The phoenix is rising from the ashes.

Recent Private Equity and LBO Transactions

Recently, Southpaw Credit Opportunity Fund FTE Ltd. raised \$570 million from 92 investors putting up a minimum of \$5 million each. Southpaw is based in Greenwich, Connecticut and is an event driven private equity fund focused on deep-value distressed and special situation opportunities. And Solar Capital Ltd., a business development company headed

by a former Apollo founder, recently raised \$200 million to purchase leveraged and mezzanine loans. Fundraising by smaller and middle sized private equity funds has been strong.

Listed below are examples of recent LBO/merger and acquisition transactions.

<u>DATE</u>	<u>TRANSACTION</u>
3/2/2010	Prudential PLC acquisition of AIG Asian life insurance business for \$35.5 billion.
3/3/2010	Hedge fund Elliott Associates LP bids \$1.8 billion for Novell Inc.
3/3/2010	Dow Chemical to sell Styron plastics business to private equity fund Bain Capital Partners for \$1.63 billion.
2/3/2010	Private equity fund Platinum Equity of Beverly Hills buys Wood Manufacturing/Genmar holdings, \$1.1 billion in sales.
2/11/2010	Affiliated Managers Group Inc. acquires Pantheon Ventures, London private equity fund of funds, for \$775 million.
2/25/2010	SkillSoft of Dublin (UK) \$1.1 billion - sale to Berkshire Partners, Advent, Bain Capital - in going private transaction.
2/12/2010	Oak Hill sells Duane Reade to Walgreen \$1.1 billion.
2/16/2010	Express retail chain \$200 million IPO, owned by Golden Gate Private Equity Inc.
2/2010	Simon Property Group \$10 billion all cash bid for General Growth Properties.