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## Private equity: Five lessons from the GFC

Here's how the takeaways from the crisis inform PE practitioners facing a formidable debt wall and stubbornly high interest rates

UNTIL the 2008 credit crunch, the conventional recipe for success in private equity (PE) was straightforward: Just pour in debt and stir. A generous dose of leverage typically spiced up the financing of a transaction.

But the global financial crisis (GFC) turned this money pie into mush. Government-backed purchases of toxic assets – funded by central bank purchases of government bonds – eventually engineered a comprehensive bailout of distressed borrowers and other heavy debt users. With loose monetary policies throughout the 2010s, leverage returned with a vengeance.

What to expect from a downturn

So if a recession comes, how can the lessons of the GFC inform PE practitioners facing a formidable debt wall and stubbornly high interest rates? Here's what to watch for:

**1. A mass shakeout:** Post-GFC, one in four buyout firms never raised another fund, according to Bain & Company's *Global Private Equity Report 2020*. Without the central banks' rescue package of zero interest rates and quasi-unlimited credit, the damage would have turned into carnage.

Some firms were forced into liquidation, including top-10 European buyout shop Candover Investments. Others were sold out in distressed transactions or simply spun off, including the proprietary PE units of troubled banks Lehman Brothers and Bank of America Merrill Lynch. A capital drought forced many more to work deal by deal.

The fund managers that survived the GFC knew they had a lucky escape. To avoid leaving their fate in the hands of regulators and monetary authorities, the larger operators have morphed into financial supermarkets over the last 15 years. That transition had less to do with fostering economic growth than protecting and diversifying fee income.

Global consolidation is to be expected and US PE groups will once again lead the charge. In 2011, Carlyle bought the Dutch fund of funds manager Alpinvest. Five years later, HarbourVest acquired the UK firm SVG, a cornerstone investor in Permira.

More recently, general partner (GP)-stakes investors, such as Blue Owl, specialised in the acquisition of large shareholdings to provide liquidity to PE fund managers. Blue Owl's former incarnation – Dyal Capital – took a stake in Lon-



Because most credit deals in recent years applied floating rates, should the cost of credit remain high, zombie scenarios, Chapter 11 filings, and hostile takeovers by lenders could spike. PHOTO: AFP

don-headquartered Bridgepoint in August 2018, for instance. Blackstone has been one of the most active acquirers of stakes in fellow PE firms, and announced in April 2020 – amid pandemic-related uncertainty – that it had US\$4 billion in cash available for such purchases. Today's tight monetary policies offer similar opportunities.

**2. Portfolio cleansing:** According to the UK-based Centre for Management Buyout Research (CMBOR), 56 per cent of PE portfolio exits in Europe in the first half of 2009 were distressed portfolio realisations such as receiverships and bankruptcies. By contrast, at the peak of the credit bubble in the first half of 2005, this cohort accounted for only 16 per cent of exits.

In the United States, the number of PE-backed companies filing for Chapter 11 was three times greater in 2009 than two years earlier. Likewise, in 2020, nationwide lockdowns caused almost twice as many bankruptcies among PE portfolio companies than in the prior year despite comprehensive government bailout initiatives.

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nanial sponsors wary of injecting more equity into portfolio companies with stretched capital structures may emulate KKR's decision last year to let Envision Healthcare fold and fall into the hands of creditors.

**3. Flight to size:** Although PE powerhouses came under pressure in the wake of the GFC, with some critics gleefully predicting their demise, capital commitments should keep on flowing as long as fund managers control the narrative around superior investment returns.

The risk for prospective investors is confusing fund size or brand recognition with quality. The Pepsi Challenge proved years ago that, in a blind taste, consumers preferred Pepsi to Coca-Cola, yet they continued to buy the latter partly because they wrongly associated advertising spend with superior taste.

There is no blind taste test in private markets, so don't expect a flight to quality but instead a crawl to safety. Limited partners (LPs) will avoid the risk of switching to less well-known fund managers, irrespective of performance.

**4. Reshaping capital deployment:** If a potential recession is not coupled with a financial crisis, the private markets correction ought to be mod-

erate. Fundraising, nevertheless, is already becoming a drawn-out process. Institutional investors, or LPs, are committing less capital and will do so less frequently. Firms will raise vintages every six to eight years as in 2008 to 2014 rather than every three to four years as during the money-printing bubble of 2015 to 2021. In anticipation, several fund managers have established permanent capital pools to reduce their dependence on LPs.

To address distressed situations, fund deployment will focus on portfolio bailouts, assuming some value remains in the equity. PE fund managers will pursue risk-averse strategies such as continuation funds and buy-and-build platforms, backing existing assets rather than closing new deals.

Secondary buyouts (SBOs) will still represent the main source of deal flow, even if, in a high-interest-rate environment, these often-debt-ridden businesses may struggle.

Corporate carve-outs may be another source of deals. In the wake of the GFC, many companies had to dispose of non-core activities to protect margins or repair their balance sheets. Five of the 10 largest leveraged buyouts (LBOs) announced in 2009 were carve-outs. This trend could re-emerge amid a higher interest rate climate in which a growing number of corporations qualify as zombies, with earnings not covering interest payments. The Bank of England predicted that half of non-financial companies would have experienced debt-servicing stress by the end of 2023.

**5. A credit squeeze:** The immediate fallout of higher credit costs is falling debt multiples and a more complex syndication process. In the midst of the GFC, some practitioners criticised the pernicious business model adopted during the credit bubble.

In a 2008 book, French PE firm Siparex remarked: "Siparex ... did not apply excessive leverage on mega-buyouts that today prevents the syndication of bank loans ... We have nothing in common with KKR or Carlyle. When one hears Henry Kravis ... declare that a company is a com-

modity, it makes one's hair stand on end."

Without quantitative easing (QE) throughout the 2010s, syndication headaches and portfolio distress would have remained the norm. This time around, the central banks seem more intent on reining in inflation than on keeping over-indebted businesses afloat. That could reduce demand for credit over a long period.

This time is (a little) different

The current inflationary context led to higher interest rates, whereas the GFC inspired zero-interest-rate policies. High credit costs are curbing deal activity and will frustrate the refinancing of portfolio companies, reinforcing the notion that PE is intrinsically cyclical.

The financial markets are not likely to face a credit crunch on the scale of the GFC. Nevertheless, on the back of more than US\$20 trillion of Covid-19 stimulus in 2020 alone, the main central banks' balance sheets are extremely stretched. Quantitative tightening rather than QE is de rigueur. The slowdown recorded in the first quarter of 2023 – with deal activity down 30 per cent year over year – could therefore accelerate. The value of PE exits in the third quarter of 2023 was the lowest of any quarter since 2008. As a reminder, according to Bain & Company's *Global Private Equity Report 2011*, between 2006 and 2009 global buyout deal values fell 90 per cent.

Since 2022, bank lending has been tightening. As a cautionary tale, between 2007 and 2009, leveraged loan volumes shrank by 85 per cent. For now, private debt fund managers are picking up the slack and deepening the commitments they made as banking regulation tightened over the last decade. These shadow lenders seemed to be offering looser terms than conventional leveraged bankers, but given the lack of reliable information in private markets, this is a dangerous generalisation.

A new breed of lenders

The sloppy lending practices that first appeared during the credit boom of the early 2000s gradually re-emerged in the QE bubble of the 2010s.



Blackstone's recent attempt to recoup loan losses from Bain Capital on a deal gone sour shows that private capital firms with market power can afford to be more aggressive. PHOTO: REUTERS

Minimum hold levels that influence a lender's required participation; "Yank the Bank" provisions by which a borrower can unilaterally pay off a dissenting lender; "Snooze and Lose" clauses that force lenders to either respond to amendments on a tight deadline or grant implied consent; and covenant mulligans – which require a financial covenant breach in two consecutive quarters before a lender can call default – all re-entered the mainstream in the lead-up to the Covid-19 pandemic.

Private debt fund managers may put more pressure on PE-backed companies, especially if they realise that the looser terms granted in recent years could cost them a sizeable slice of their capital in distress scenarios. Unlike commercial banks, private lenders do not serve individual depositors and prefer to preserve their investors' capital than develop long-term relationships with distressed borrowers. That the private credit segment is concentrated among several major institutions, giving them significant bargaining power, will only compound this situation. The top 10 credit funds account for about half of global annual capital commitments.

This should not be overstated, however. While private debt firms might not focus as much on relationship banking as traditional institutions, they will still want to behave commercially to remain active in buyout financing.

PE fund managers are repeat dealmakers. Should a private lender ever treat them too harshly, they could shop elsewhere.

Blackstone's recent attempt to recoup loan losses from Bain Capital on a deal gone sour shows, nevertheless, that private capital firms with market power can afford to be more aggressive.

A tougher stance from non-bank lenders would make refinancings more costly and affect performance.

Anecdotal evidence suggests that buyout deal-doers are contending with stricter financing and restructuring terms, and equity cures could be making a comeback. The equity portion of LBO structures already exceeds 50 per cent. That will impact investment returns.

As deal proceeds and debt multiples suffered during the credit crunch, 2005 to 2006 PE vintages recorded internal rates of return in the single digits compared to mid-double digits for 2002 to 2003 vintage funds.

Predictably, after reaching high double-digit territories during the pandemic, investment returns came crashing down at the back end of 2022. That's the main takeaway from the GFC: as monetary policies tighten up, PE performance generally backslides.

The writer is a private capital advisor. He has worked as an investment executive for multiple fund managers. He is the author of *The Debt Trap and The Good, the Bad and the Ugly of Private Equity*.