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Very public pain of private equity

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THE humiliating collapse this week of Australia's biggest variety retail chain, with 400 Crazy Clark's and Go-Lo variety stores, says as much about the attitude of banks to the erstwhile masters of the universe - private equity - as it does about the financial pressures that private equity operators are battling.

The difference of a few million dollars in what the banks wanted, and what the private equity operators Catalyst and Champ were prepared to put in, decided the fate of 2700 staff and 400 stores, and put the first real blemish on private equity.

The sale process kicks off next week and it is understood there have already been a few expressions of interest.

But it is early days and Australian Discount Retail will be the first of a long line of assets, bought by private equity at the top of the market, which won't make the distance.

Besides Myer, some of the retail deals sold to private equity in the past couple of years include Barbeques Galore, backpacking chain Recreational Tourism Group, Witchery, Colorado, Super A-mart, Kathmandu, Repco, Amart All Sports and Rebel Sport, all using mountains of debt.

Assets in the mining services sector, including Valley Longwall International, which was bought by Catalyst in 2007, and Barminco, which was bought by Gresham Partners in 2007, are also believed to be struggling as the mining sector winds back globally.

Conglomerate Wesfarmers last week wrote down part of its $225 million exposure to Gresham's two private equity funds.

Others, including CCMP and Private Equity Partners, are also believed to be looking to sell Independent Liquor, which it acquired for $NZ1.3 billion at the top of the market.

The business has since deteriorated and has been unofficially on the market for the past six months.

Les Fallick, the founder and managing director of Principle Advisory Services, goes so far as to estimate that six to 10 private equity operators will cease to exist in the next 12 months.

There are currently 30 private equity firms in Australia, which means a third could be wiped out -- along with billions of dollars of shareholders' money -- by 2010.

Fallick, whose business acts as an adviser and capital raiser to the institutional investment market and private equity industry, believes 2009 will be the most difficult capital-raising environment in a decade.

"There will be an almost complete drying up of US and Middle East money flowing into private equity funds and a significant fall in the average size of funds," he says.

In the past year, private equity deals have become scarce, floats and trade sales have been delayed, and most of the deals done in 2006 and 2007 are in dire straits.

Already companies such as boat maker Riviera and Nine Network have been forced to inject more equity into the businesses, and the talk is that most of the assets bought by private equity in the retail sector over the past few years are under pressure to do the same.

Besides debt refinancing issues, clients are also posing a problem for the private equity operators. The issue is liquidity. Private equity funds are essentially illiquid and superannuation funds are facing an increase in redemptions.

The superannuation funds are also complaining of the "denominator effect" when it comes to private equity and asset allocation.

This is expected to force the sell-off of billions in private equity and alternative investments.

In the year to June 30, 2008, $6.1 billion was raised in private equity, versus $10 billion the previous year. The 2009 figures are expected to be a fraction of this, which will threaten the viability of some private equity funds.

The problem is this: as the public markets have collapsed and the prices of liquid assets have plummeted, the value of the overall portfolio, or the denominator, has shrunk. This means allocations to private equity funds, which aren't priced often, have held -- at least in theory -- and so the weighting has gone up.

The way to fix it is to reduce the exposure to private equity, generally through the secondary market, according to Sam Armstrong, co-founder of Barwon Investment Partners, a business that manages funds on behalf of institutional clients seeking investment in alternative assets.

Armstrong says a secondary market is starting up in Australia that trades pre-existing commitments to alternative asset funds at a discount. Some buyers are bidding as little as 50c in the dollar, depending on the fund and the future commitments of the fund.

"We expect to record levels in the global secondary market this year," he says.

Previously, about 2-3 per cent of private equity commitments changed hands globally, but this is expected to jump to 7 per cent this year.

There will also be an increase in the number of listed vehicles that go private. In Australia in the past few months, Colonial First State Private Equity, Macquarie Private Capital Group and Macquarie Capital Alliance were taken private. Something is also likely to happen with Allco Private Equity.

There is also talk in the market that some superannuation funds will pressure the private equity funds not to delay drawing down precommitments.

The way it works is that private equity funds raise money for a fund, super funds precommit a certain amount of money to the fund, and when the private equity operators find an asset or need more money, they draw down the precommitted money.

At a time when superannuation funds are suffering their worst returns in history and redemptions are on the rise, it is no surprise that rumours are rife that at least one staff super fund in the financial services sector has warned a private equity fund that it will default if it draws down funds.

This is already happening in funds overseas, and there is little doubt that super funds will start putting pressure on private equity funds to improve their performance and reduce their 2 per cent management fees.

Chester Moynihan, the managing director of Allegro Private Equity, says 2009 will be an even tougher year for private equity as funds reach the end of their committed capital and seek to raise new money.

"What will happen then?" he says. "They will be screaming out for new equity in an environment where there is little demand to put money in, particularly given it is difficult to exit."

Moynihan recently won the mandate to manage ABN AMRO's $300 million private equity fund after its manager was sacked for poor performance and the collapse of one of the assets, Pure Logistics.

The fund's investments include fertility clinic Monash IVF, NSW-based retailer Babies Galore, caravan park group Discovery Holiday Parks, medical supplier CH2, transport group Pure Logistics and non-conforming mortgage lender Bluestone.

Like all private equity operators, Moynihan is in discussions with the banks over loan covenants with various assets in the portfolio.

"For us, the focus is working with underperforming business and doing everything in our power to give the banks confidence that they will be repaid," he says.

But he says it is not so arrogant to think that what happened to ADR was a one-off occurrence. "We inherited a portfolio business that was underperforming before the financial crisis and we are working our way through it," he says.

He says the task of Allegro is to improve the performance of the fund by improving operational performance.

"The private equity model has changed. We are excited by this change because we think the returns will come from operational improvement and not many people in that industry have the depth or track record," he says.

The problem is threefold: debt is too high; repayments or covenant breaches are being triggered; and there is a reluctance by the banks to refinance highly leveraged businesses.

Worse still, a number of the friendlier and bigger financiers to private equity are withdrawing from the market. One of the biggest funders of debt to private equity, structured finance group BOS International, is believed to be for sale.

Industry sources estimate there is more than $18.7 billion of private equity debt that needs to be refinanced and of that a good proportion is syndicated debt with foreign banks the main players.

As one investment banker says: "The senior and mezzanine debt markets are voting with their feet."

The senior debt of another dozen private equity deals is currently trading between 65c and 88c, which is not a good sign.

But out of the mess there are options arising. Blake Dawson Waldron partner James Marshall says that as debt becomes increasingly expensive, investors are starting to emerge in the secondary debt market.

"Funds and investment banks are setting up businesses aimed at distressed assets with debt," he says.

Debt is expensive and so is offering high returns. Indeed, if it is secured debt, it is less risk than equity in the event that the business goes under.

Merrill Lynch Hong Kong is setting up a debt fund, and in Australia, Fortress and Shearwater Capital are setting up debt funds.

As asset prices collapse, funds such as PEP which are sitting on billions of dollars of cash, will be in the box seat to make a killing.

Andrew Thompson, a partner at KPMG and head of its private equity practice, believes the death of private equity is enormously exaggerated. He contends that a lot of people use illiquid assets and will keep doing so.

The recent MYOB sale to a joint venture between private equity firm Archer Capital and US investment firm HarbourVest, at $450 million, is a case in point.

He also says there is $2 trillion allocated to the sector globally, with $700 billion still to spend. That figure is estimated to be $10 billion in Australia. "The great question is what the debt piece will be," he says.

"The absolute best time to invest is when there is blood on the streets."

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