

## Short-term debt bottleneck or long term crisis?

**Olivier Assant** is a Partner in the leading French law firm Bredin Prat with extensive experience in all facets of corporate law. He specializes in transactional work with a focus on cross-border public and private M&A, private equity transactions as well as bankruptcy/restructuring and dispute resolution. **Olivier Assant** has recently advised among others : Lagardère on a number of its acquisitions and disposals; Thomas Cook on its acquisition of Jet Tours; SAP on its acquisition of Business Objects; General Electric Company on its acquisition of Smiths Aerospace; Robert Louis-Dreyfus on the acquisition of a controlling stake in Groupe Louis Dreyfus; Saint-Gobain on its disposal of Desjonquères to private equity funds; Aventis on its defence against the €50 billion hostile offer of Sanofi Synthelabo; Clayton Dubilier & Rice, Eurazeo and Merrill Lynch Private Equity on their acquisition of Rexel from PPR; Eurazeo on its sale of Lazard within the context of Lazard's IPO.

At the 7th edition of the Private Equity Exchange **Olivier Assant**, Partner at Bredin Prat's Paris office, presented and moderated a panel of 3 other prominent private equity figures: **David Novak**, Partner at Clayton Dubilier Rice, **Axel Holtrup**, Director at Silver Lake, and **Gregory W. Conway**, Managing Partner at Simpson Thacher.

### **Olivier ASSANT: Reflecting on whether the current situation is a short-term bottleneck or a long time crisis, how, do you think, the global financial system got into such a mess?**

**David NOVAK:** There is an evolutionary process that led to the crisis, and there are 5 main factors explaining this "mess".

Firstly, the deregulation led to the proliferation of financial products and non-banking lending sources which were far less monitored by regulators. Secondly, the expansion of liquidity, created by central banks' expansionary monetary policies on one side and the globalization of finance on the other side, resulted in huge amounts of capital travelling very quickly across borders to the most profitable markets. Thirdly, there was an impressive growth of different companies' leverage.

Then there are also the things that people "missed". The misjudgement about the correlation of financial assets and the correlation between classes of assets was widespread. It is true that the mortgage crisis has been the starting point of the financial and banking crisis, but it was magnified by the fact that supposedly "uncorrelated" assets, securitized and highly rated, had in fact significant correlation in their risk and performance.

The fifth factor, as a consequence, is the mispricing of risk, and it was significantly amplified by very low credit spreads that led to accelerated syndication process.

**Gregory W. CONWAY:** Today, criticism is that the credit agencies failed in their job to rate risk appropriately, private equity actors are greedy, and banks are not doing their job of financing the economy. But everybody fed this vicious circle: CEOs and CFOs wanted to own these assets (coming from securitization). The problem is that credit decisions in banks became syndication decisions, thus there was a very poor credit screening.

**Axel HOLTRUP:** It is an unprecedented situation. Initially, it was the USA problem with little impact on Europe, but Bear Sterns being placed into receivership in March led to a chain reaction, with a focus on cash preservation, an increased cost of equity, a fall in capital supply, and a counterparty panic with a complete loss of trust and high liquidity problems, as demonstrated by the bankruptcy of Lehman Brothers.

**David NOVAK:** Fifteen years ago the credit process was a very heavy process. Private equity general partners presented directly their projects to the partners of the banks' credit committees. Before the crisis, it was more like private equity funds' associates presenting to associates or even juniors of banks' credit committees. This shows credit screening became less important because what mattered was to "securitize and sell as quickly as possible".

**Olivier ASSANT: What are the expectations on the global equity and debt markets for the months to come?**

**Axel HOLTRUP:** There is a real possibility that the financial system would evaporate to the profit of government, being the sole actor able to restore trust, especially with the fact the financial crisis spilled into the real world with a recession in developed countries. Even if the worst of panic selling is behind us, there is a massive deleveraging exercise in the economy (banks, hedge funds, etc.) that will probably last for the next 2-3 years. We cannot expect a rapid recovery.

**David NOVAK:** The real question is how the market will deal with the mispricing of risk. The current very high aversion to risk and the deleveraging process shows that we need a new understanding about how to think about the risk. Part of the answer will be driven by how the real economy will respond in the next 2-3 years and how governments will respond.

**Olivier ASSANT: What does this crisis mean for the private equity industry? Alternative private equity strategies will be created around the distressed debt, but then there is clearly no financing for big deals. There is also the debate about debt buy-back being today a very attractive option for portfolio companies in the actual market conditions. How do you see the private equity going forward?**

**David NOVAK:** The crisis highlights the liquidity issue for private equity operations. The past shows that more than 90% of LBOs' bankruptcies were due to liquidity problems. And we need to underline the difference that exists in terms of liquidity between the US and the European markets: US market is more liquid, thus making the current crisis less tough for the US private equity, whereas in Europe there is less excess liquidity, which complicates the situation for European private equity.

**Axel HOLTRUP:** Pockets of liquidity (sovereign wealth funds) still exist but they have a lot of choice and thus there is an intense competition to be the recipient of this liquidity. But for sure, we cannot expect a short-term revival of traditional LBOs with very high leverage. So the question is how to make good investments in equity without leverage? We need to reinvent ourselves.

**Gregory W. CONRWAY:** We need more long hold deals with true partners that just don't buy and sell. IPO's will come back, even if the secondary LBOs' market (leverage on leverage) is dead. But there are still opportunities, even if they come with more constraints. We also need more teaming-up with strategic investors: equity becomes more valuable because given the current market conditions and fall in stock prices more and more firms are afraid of becoming a target.