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## Private Equity: The New Order Now Begins

In "Atlas Shrugged," Ayn Rand wrote, "There is no such thing as a contradiction. If you think you are faced with a contradiction, check your premises and you'll find that one of them is wrong."



(Courtesy of Credit Suisse)

The world of private equity is finding that nearly every one of its premises is, if not wrong, then certainly challenged. The closed debt markets have made it nigh impossible for private equity firms to find financing – a cutting blow, since financing, or leverage, is the core of how they pay for companies. Then there are the increasing tensions with limited partners – the pensions and endowments that put money into PE. And let's not even discuss the debate over how private equity partners should be taxed – a hot-button issue in which Washington lawmakers have portrayed private equity investors as rich, greedy, and due for a tax comeuppance.

Deal Journal interviewed Nicole Arnaboldi (*left*), Chairman of Credit Suisse Group's DLJ Merchant Banking Partners, for a look at how the private-equity world has changed. Arnaboldi also talked with us Thursday as one of the keynote speakers at the Women's Private Equity Summit; the conversation that follows is a reprise of the high points we discussed.

**Deal Journal:** *One of the biggest changes in private equity is how relationships with lenders have become more combative. What do private-equity firms need to know about banks?*

**Nicole Arnaboldi:** I think a lot of PE firms are going to be in discussions with banks over covenant issues, restructurings and so forth. A lot of private-equity firms may not have the relevant expertise to enter into those negotiations properly. You'll see great growth in private-equity firms calling on restructuring expertise.

**Deal Journal:** *What can restructuring experts bring to the discussion?*

**Arnaboldi:** Restructuring firms can bring expertise in what banks are doing in comparable situations. They can say what banks have done and what they will do. They can also be the intermediary where the lender and the PE firm have a lot of, let's say, water under the bridge in terms of the previous relationship. It's effective to have a restructuring firm as a parallel intermediary on the private-equity side to the loan workout or restructuring groups that the banks may have if the debt defaults.

**Deal Journal:** *How are private-equity firms picking the right price for their assets, whether they are trying to buy or sell?*

**Arnaboldi:** The pricing of assets and the valuation issues are big. There is some controversy over mark-to-market accounting as well. We're seeing unbelievable variances in where people are carrying assets and where sale prices are. One example is a hedge fund that bought a bank loan for 10 cents on the dollar in the secondary market, and shortly afterward another firm bought the same security at 45

cents on the dollar, and other holders hold it at 100 cents on the dollar. That's three different prices for the same loan. So what's the mark-to-market value on that?

**Deal Journal:** *How are private-equity firms valuing the companies they have invested in? Are they just figuring out what values they would hold in a liquidation?*

**Arnaboldi:** With the accounting rule FAS 157, there have been a lot of discussions around this topic—how do you apply it when we're in a distressed market and there are few transactions? It's difficult particularly if you, as the PE holder, are not selling any assets. The concept of fair value is what a willing seller and a fair buyer would pay, and the PE firms right now are not choosing to sell because of market conditions, so the market value is difficult because there are a few willing buyers but no willing sellers—there are only distressed sellers. There is a lot of discrepancy in the accounting world. We have autonomous reviewers in our firm, outside reviewers, and of course we have the [Federal Reserve] and other regulators. We have done a good job of having a well articulated process and applying it. The real challenge for investors is when they read their statements, they don't know what the fair value is. It's not bad faith on the part of any private-equity manager; it's just a difficult exercise.

**Deal Journal:** *Private-equity firms are struggling with a lot of failing or troubled companies. What leeway do they have to put more money in them?*

**Arnaboldi:** That will be one of the biggest issues for some of the private-equity funds, because they didn't anticipate the capital needs of their companies. There are two ways they can address it: one is to raise a subsequent fund, but it's a difficult fund-raising environment and it opens up the problem of cross-fund investments. The second option is to open up an existing fund [Deal Journal aside: for instance, one that was started in a previous year] to get new capital in that fund. The general partner [Deal Journal: that means the managers of private equity funds] may be motivated by performance fees to invest fresh capital in companies that are deeply impaired. Performance fees are a percentage of the fund's investment gains.

Putting fresh capital into that situation – the expanded fund– is something limited partners should look at with a cautious eye. If you're an LP and you have an investment have a fund that's deeply underwater, is that putting good money after bad?

**Deal Journal:** *What advice do you have for pension funds and endowments that devote retiree and alumni money to private equity?*

**Arnaboldi:** On one level, be cautious about the current market environment in making new commitments, but remember the best opportunities come when times are bad.

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