Private equity's future in a deleveraging world

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As the liquidity crunch curbs cheap debt, private equity will shrink dramatically, and a smaller, more vibrant industry will reemerge.

Private equity is under assault. The current reckoning that is unfolding is a dramatic contrast to the overconfidence that prevailed in large swaths of the private equity market as recently as a year ago.

In order to understand how the private equity industry got into this predicament and where it goes from here, it is important to go back to the beginning. The American private equity asset class was formalized almost 30 years ago. At that time, the dominant corporate structure was the conglomerate. These conglomerates were run, largely, by managers with a limited economic stake in the performance of the stock of their companies. In addition, the myopic focus on quarterly accounting earnings, as opposed to cash earnings, obscured the true intrinsic value of many companies and precluded any difficult restructurings.

In this context, the rationale for the private equity asset class was simple. Private equity managers would invest long-term capital in poorly run companies, undertake complicated reorganizations that were not possible in prior corporate forms, and would exploit market inefficiencies. This would be accomplished by employing the discipline of debt, relentlessly focusing on cash generation, and creating fundamental operating improvements at these companies. In addition, private equity managers would put their own money into the fund, and get the bulk of their compensation in the form of a percentage of cash profits on the investments, aligning the incentives of managers and investors. If done right, the capital invested would earn above average returns in order to compensate investors for the illiquidity of and increased risk through leverage on their investments.

On the fringes

For over 20 years the best private equity managers delivered on this promise. They consistently outperformed public indexes by wide margins. This performance was accomplished by operating on the fringes of the financial system, as is logical for an asset class exploiting inefficiencies. Private equity managers also operated away from the limelight. Despite the occasional "barbarian at the gates" moment, most business people and media would have been hard-pressed to name more than a handful of firms, individuals, or investments associated with private equity.

All this began to change in the early part of this decade. The historic outperformance of the asset class coupled with a surge in liquidity unleashed by the global central banks led to historic amounts of equity and debt capital being invested in the industry. Increasing asset prices meant increasing profits for investors, which in turn led to more capital flooding the industry as investors further increased their allocation to private equity. A stampeding herd of fund of funds, retail investors, and international investors followed the traditional investors into the asset class. Approximately $600 billion was committed to private equity from 2005 through 2007. This capital was more than the cumulative capital committed to the industry in its prior 30 years. Over 90% of this capital was committed to larger funds. Smaller funds which plied the traditional private equity trade barely grew in the past decade.

Private equity deal volume grew almost eightfold from 2000 to 2007, and an industry that operated at the fringes of the financial system moved to its center. The total capital invested in private equity deals went from being 3% of all deals in 2000 to almost 25% of all deals in 2007. These deals were done at ever-increasing multiples of what turned out to be peak

economic cycle profits and financed with ever increasing levels of debt. Both valuation multiples and debt-to-cash-flow multiples rose by almost 50% in this short time frame, most egregiously for the larger deals.

Serious misalignment

These golden years undid the key rationale for the asset class. More profits could be generated through financial engineering than improving operations of companies.

Holding periods declined as private equity managers flipped companies quickly, often to other private equity investors. Management fees paid to the managers ballooned to a point where there was serious misalignment in incentives between managers and investors. While getting a share of the cash profits on investments was still important, managers could become wealthy on the basis of management fees alone. Perhaps most important, an asset class that flourished by exploiting inefficiencies in the market became the market itself.

The bursting of the credit bubble is hitting the private equity industry in multiple ways. First, the returns on many funds invested primarily in the 2005-07 time frame will be significantly sub-par. Paying historic high multiples of cyclically high earnings and financing that with historically high leverage is a nasty cocktail that will leave a really bad hangover. In research published recently, Boston Consulting Group estimates that at least 50% of the private equity deals done in the recent past will default on their debt. Second, investors who were yearning for yield are over-allocated to private equity and reeling from the massive declines in the value of all asset classes. Finally, the liquidity crunch has changed the availability of cheap debt to the asset class for a long time.

As a result, the private equity industry will shrink dramatically in the next five years. Approximately half the firms need to raise capital for new funds in the next two years. Given the rapidly declining new commitments from endowments and pension funds and the expected poor performance of recent investments, only the very best firms will be able to brave this challenge.

This dislocation is not only good but essential for the future viability of the private equity business. As credit-bubble-fueled firms are culled, a smaller more vibrant industry will reemerge. Financial whiz kids will cede power to people who know how to run and fix businesses. The industry will become highly profitable again as demand for private equity capital exceeds its availability. And perhaps most important, private equity will recapture its essence by receding back to the sidelines of the financial world, looking for tough, messy restructurings to undertake. For the patient practitioner of private equity, this will be a welcome development.

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