

**Special Report**

# After Private Equity:

Will it End?

What Happens Next?

June 2007

How will the current boom in private equity end? It's tough to say with any degree of certitude, but we can predict how it will not end: The buyout boom will not produce a new paradigm of corporate ownership in which a sizable share of U.S. companies are privately held.

The virtues of private ownership are widely touted by private equity managers and affiliated financiers as a key justification for the ongoing takeover binge. To hear private equity pros tell it, public ownership is as dated as yesterday's newspapers. Public companies can never fully concentrate on developing their core businesses because of the oppressive burden of regulation, the short-term focus of Wall Street/analysts and the constant pestering by "stakeholders" of various stripes. These distractions produce inefficiencies that can instantly be erased, their thinking goes, with a little private capital and a whole lot of leverage.

We wouldn't go so far as to say that private equity boosters are being disingenuous in these arguments. To the contrary, we think there is much truth in what they say, and we wholeheartedly agree that private equity buyers can make hard decisions about layoffs, cost reductions, recapitalizations and strategic shifts that often are beyond the reach of more timid and conflicted public managers. But we also believe that LBO chieftains' professed love for the private model is temporal to a degree: Once they have nurtured their current crop of takeover targets for the usual two to five years, they will sing hosannas to the public model — which is likely to enjoy a resurgence — and register for IPOs faster than you can say Sarbanes-Oxley.

### **An Exit Needed**

The reason is simple: Private equity needs an exit. Private equity managers do not acquire companies to operate; they acquire companies to sell. They do not earn their living from corporate operating profits; they make their millions from management fees derived from the returns they

produce on their investors' assets, from "dividend recaps" they pay themselves, and ultimately from the sale of their portfolio companies.

That all-consuming need for an exit is the key fact in the existence of private equity firms, and must underpin any thinking on how the private equity boom will end, and what might come after for private equity shops, portfolio companies and investors. The traditional exits pretty much boil down to these two: A private buyer can either sell a portfolio company to another private buyer, or it can sell it to public investors via an IPO. However, a fascinating third option has just emerged (see Wall Street Journal, "Goldman Takes Private Equity to a New Level," 5/24/07): a private exchange on which institutional investors — no individual retail investors allowed — would be able to buy shares of non-SEC registered private companies.

None of the three is a perfect solution to the threats that continue to hover over the industry. To wit: A private equity shop, in theory and usually in practice, takes a company private, works its turnaround magic, and then sells the company at a profit. But a troubling hole has developed in that rosy chain of events. These days, many new private equity shops lack the operational expertise required to generate efficiencies and generally add value to portfolio companies. At the same time, many investors today are arrivistes in their own right — pension funds new to the private equity world that find themselves unable to access the handful of genuinely top-notch, well established private equity managers. But that hasn't deterred these investor latecomers, who wind up putting their money into second and third-tier firms that in all likelihood will never be able to deliver the kinds of returns pension fund managers read about in the papers. (Investment consultant Watson Wyatt recently issued a report warning pension funds to steer clear of private equity investments unless they have the resources to identify and gain access to the industry's best-performing funds.) The upshot: pressure to do deals that make less and less economic sense.

## Concerns About Overleveraging

There are other threats even more menacing. One is overleveraging. The competition for deals has driven prices skyward; buyers on average are spending about 12.1 times a target's cash flow, compared to 10.4 times last year. As Carlyle Group co-founder David Rubenstein told the Wall Street Journal on May 29 ("Private Equity: Is Deal Frenzy Nearing an End?"): "Greed has taken over. Nobody fears failure."

At the same time, the current lending environment is about as fast and loose as it gets. So-called "covenant-lite" loans designed to entice borrowers have ballooned to \$64.5 billion in the first four-and-a-half months of 2007, up from only \$8.2 billion in the same period a year ago — and double the total for the entire prior decade, according to S&P. Total loans to companies bought by private equity firms has skyrocketed to \$317.3 billion in 2006 from \$51.5 billion in 2002, according to Loan Pricing Corp. Even Bank of America CEO Ken Lewis told an audience in Zurich in early May: "We are close to a time when we'll look back and say we did some stupid things." And on May 17, Fed Chairman Ben Bernanke sounded a warning to a Chicago audience: "[There are] some significant risks associated with the financing of private equity."

## Credit is Key

Finally, most predictions about how the current buyout binge will end involve a "credit event" that significantly decreases the availability and increases the cost of the credit that powers big private equity deals. Such an event — which could easily coincide with a stock market downturn — will certainly put the brakes on a sizable part of private equity deal flow, but it could also put significant pressure on companies that have been bought out in the recent past by firms using large amounts of leverage. In a worst-case scenario, some private equity managers would find their portfolios filled with companies that they

can't unload and that can't access the financing they need to fund operations and service their inflated debt loads.

However, we are not convinced that even a worst-case private equity meltdown would necessarily pose broader or "systemic" economic risks. Of course, an increase in corporate defaults and bankruptcies is never good news, and generally goes hand-in-hand with an economic and market downturn. But even though private equity firms are adding every day to the ranks of highly leveraged companies, it does not necessarily follow that they are increasing market-wide default or bankruptcy risk. Their own capital injections and the operational improvements they make to ailing companies certainly decrease the risk of bankruptcy in certain cases. Likewise, the danger to banks will be determined in large part not by the aggregate amount of loans they've made to LBO shops, but by how much of these loans are still being held on banks' own books when and if the default rate spikes.

## The Coming Correction

In uncertain times such as these, it is useful to remember the old market truisms that have proved their soundness over the generations: "Trees don't grow to the sky... All booms come to an end... All bubbles burst in the end." So it shall be, in our opinion, for this spectacular private ownership boom. The signs of a market top are pretty much everywhere, and a correction is in the offing — perhaps a severe one. However, though it will end badly for investors in select private equity firms, and for the principals of those firms themselves, it does not necessarily follow that the market at large will suffer a calamity as well. Indeed, even after the most spectacular collapse, the private equity market itself would not seize up, in our estimation. Already Wall Street is beginning to pour assets into vulture and distressed debt funds in anticipation of an increase in corporate defaults and bankruptcies (see IDD, "Distressed Hiring Points to Trouble," 5/14/07), and there are plenty of in-

vestors and managers who would view a “private equity event” as an unprecedented buying opportunity. One manager of a giant fixed-income fund we know says his firm is licking its chops, staying liquid and awaiting what he sees as a bonanza of investment opportunity when the downturn kicks in.

When viewed in that context, at least some of the arguments about the “new paradigm” of corporate ownership might well prove true — just not quite in the way private equity managers are making them today. Assuming private equity proves resilient enough to withstand and bounce back from a deflation of the current market bubble, it will have gained a permanent spot in the asset allocation charts of institutional investors (who will return after an appropriate mourning period, of course.) That more-or-less secure supply of capital will ensure that private equity funds remain a staple of the U.S. market. That will, in turn, establish private ownership as a new stage in the life cycle of U.S. companies on a large and potentially universal scale.

Historically, start-up companies have been founded by private businessmen, expanded through outside private financing, and grown until it became possible to take them public. But thanks to the many real advantages of private ownership and the proven viability of the private equity business model, many U.S. companies now face at least four stages of life — private, public, private, public — and for a few companies, even another round of private/public ownership.

But it is critical to remember that the third stage of the corporate life cycle — in which so many LBO targets find themselves these days — is not the be-all and end-all alternative to public ownership. It is a brief respite — a sabbatical from the pressures of public life. Because even if all the arguments about the superiority of private ownership are true, private equity still needs an exit.

### **Fluid Situation**

In that context, the new private exchanges being

formed illustrate the fluidity of the current situation — not to mention the creativity of some key participants. Though others are being planned, Goldman Sachs just achieved first-mover status by rolling out what it calls GS TRuE (Goldman Sachs Tradeable Unregistered Security), a private exchange accessible only to institutional investors with more than \$100 million in assets. Private companies can avoid the arduous cost and regulation of a public listing by simply listing their unregistered shares on this private exchange, provided it is owned by no more than 499 investors (any more, and it has to go public).

While the private exchange model would provide a third potential exit strategy for private equity firms, we believe private listings will prove more appealing to corporate management teams than to private equity managers. Companies might long to be freed from the rigors of public ownership, but private equity firms will remain agnostic and list companies where they feel they can extract the most value. In most cases, that will be the public markets, where individual retail investors are far more likely to overvalue a company than professional institutional investors. (Although private exchanges will provide a fascinating alternative on a case-by-case basis, or even on a much wider scale should the window slam shut on the public IPO market, as it did in 2002/2003.)

Could these private exchanges emerge as serious competitors to private equity firms? Two numbers suggest that they could: two and 20. If they gain traction, private exchanges could provide institutions with an opportunity to participate in the ownership of privately held companies while avoiding the steep fees charged by private equity managers. There is another twist as well. If they accumulate enough liquidity, private exchanges could also offer a final line of defense for public companies targeted by hostile private equity managers — a development that would make acquisitions more difficult and expensive. To press that line of defense, a public company would need to contact its biggest institutional investors, and seek an agreement to take the company private via one of the new exchanges — thereby

keeping the premium for itself and its investors that would otherwise go to the private equity shop. Such a course of action would be complex and difficult in the extreme, but nonetheless represents an intriguing possibility.

At the end of the day, if a new paradigm of private ownership does emerge in the United States, we believe it is more likely to emanate from innovations such as these new private exchanges, rather than the actions of private equity managers.

### **The Blackstone IPO**

True, some of those actions have been intriguing, with the potential for far-reaching consequences. For instance, in March Blackstone registered for an IPO that would bring in an estimated \$4 billion, setting the private equity world to talking and wondering about a wave of me-tooism that might follow. We believe this is not likely to occur on a grand scale. The price of that public capital is simply too dear for most private equity principals, and the burdens of public ownership too severe. In the end, we believe most will conclude that they went private for a reason, and elect to stay that way. The private equity model, too, is not a great fit with the public markets, as its earnings stream is lumpy and unpredictable.

Perhaps more intriguing is the \$3 billion investment China is taking in Blackstone in advance of the IPO – an ownership stake in which China will have no voting powers and, at least ostensibly, no say in Blackstone’s investment decisions. Could this portend other investments by other so-called sovereign wealth funds (SWFs)? That is a fascinating possibility, especially should private equity industry survive the looming correction in reasonable order. SWFs — the investment arms of countries as diverse as Norway, Australia, Russia and Botswana — represent the largest pool of global liquidity available anywhere: an estimated \$2,500 billion, according to Morgan Stanley. They have always been managed in

strict secrecy, and with conservatism as a watchword. But even they are being pressed to boost returns these days, along with every other money manager on the planet. And private equity may prove irresistible, though such a union would not be without significant problems — among them transparency and the potential for raising nationalistic hackles à la the failed attempt in 2005 by China’s state-owned oil company to buy Unocal.

### **Legislative Probing**

But the storm clouds of the most pressing concern to the private equity industry these days are legislative and regulatory in nature. For instance, the industry faces two separate threats from Capitol Hill. The first comes from the House Financial Services Committee, whose chairman, Barney Frank, used a recent hearing on private equity to make a populist attack on managers. Frank cited the disparities between the profits earned by private equity managers and the chopping-block fates of janitors and other employees in corporate restructurings. “When a small number of individuals benefit in the tens and sometimes hundreds of millions of dollars, and concurrently workers are laid off, we have a situation which seems to me wrong,” he said. “What are we going to do about it? It’s not clear.”

Republican members of the committee have voiced their opposition to any new regulation in clear terms. But at the same time, unions are pushing Democrats to consider broad legislation that would give labor and other “stakeholders” a larger voice. A hardened cynic might view the Frank hearings as a stage on which Democrats can mollify their union constituents without actually doing anything. But the unions continue to press on other fronts: The AFL-CIO is trying to make the case that elements of Blackstone’s IPO structure would violate securities laws.

### **Potential Tax Threat**

The second threat, from the Senate Finance Committee, is probably more real and more pressing. The panel is exploring the possibility of taxing the investment profits of private equity funds at ordinary income rates as opposed to the 15% capital gains rate. One influential voice in private equity, New York Times Dealbook founder Andrew Ross Sorkin, who often takes pro-private equity stances, opined in a March 12 column that the current lower tax for private equity gains is a “charade,” and declared that the IRS should “clearly” be considering it regular income. However, according to most media accounts, no legislation is expected until the fall.

As if that were not enough, Federal Reserve Board Chairman Ben Bernanke last week said the Fed was “beginning to look at” some significant risks associated with private equity, “including the bridge loans and participations, the wholesale, including the loans in warehousing and so on.” He urged banks to carefully evaluate the risks they were taking in financing LBOs, but he did not signal that specific regulation was on the way.

On the international front, a nascent effort to regulate private equity (outside of Germany, at any rate) appears to have stalled. According to the May 18 edition of the International Herald Tribune, Germany’s push to get its fellow Group of 8 members to endorse new private equity regulation fell flat when the United States, Japan, Britain, and Canada declined to sign on. The international set-back has not discouraged German regulators, however, as they seem determined to go it alone. Last week, the German government announced “that it would soon propose a law to require investors who build up a stake of 10% in a German company to make their intentions clear,” according to the IHT. This legislation would follow a law passed earlier this year requiring investors with more than a 3% stake in a company to disclose their holding. Meanwhile, a tax proposal so radical that it would likely drive private equity out of the country is still being bandied about in Denmark; the head of the Australian Treasury has also indicated that

he might review private equity’s tax treatment in that country.

### **Attacks Will Continue**

Of all these legislative/regulatory threats in the U.S., the most dangerous at present seems the Senate tax action, which might actually win approval in Congress and potentially avoid a presidential veto. Legislation from the House seems less likely. However, Frank and other Democrats will continue to use their public platform to demonize private equity managers, regardless of the actual legislative outcome. This continued public browbeating, both here and abroad, is not an insignificant threat: As private equity continues to grow into a dominant force in the U.S. economy, it will assuredly come under ever-greater public scrutiny. Being dragged through the mud by Congress and being dragged to the Hill to testify under oath will have long-term negative consequences for private equity and its managers, even in the absence of new regulation.