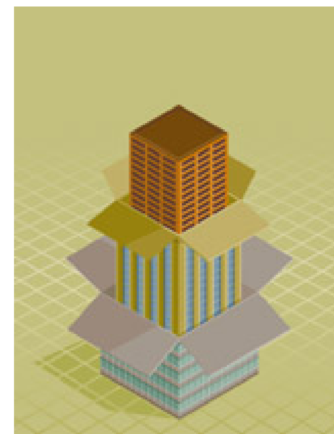
Low Rates, Mixed Valuations: Searching for Growth in an Uncertain Economy

Published : November 17, 2004 in Knowledge@Wharton



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Despite mixed economic signals that have left investors jittery, financial markets continue to fund new growth opportunities, according to speakers at last month's Wharton's 2004 Finance Conference.

Paul H. Hough, senior vice president and corporate treasurer of American Express Co., spoke of organic growth as the cornerstone of business at Amex. "If you have a business model that has strong organic growth, it allows you to think about extended opportunities beyond that core," such as new products or customer segments, Hough said during a panel entitled "Growth Opportunities: The Role of Finance in Enabling Corporate Expansion." Organic growth also gives companies the luxury of making only choice acquisitions, "allowing you to be incredibly focused in what you acquire and the way you acquire it."

According to Hough, managers at American Express think of growth as a triangle. On one side of the triangle are measures, such as revenue, that are reported to the investment community. The other side of the triangle is made up of more internal considerations, like return on equity. The base of the triangle is stability. "What we have found is that companies that return the greatest shareholder value on average over time are companies that deliver growth in a very stable environment. What the investment community does not like are surprises."

Leroy T. Barnes, vice president and treasurer of California utility PG&E, said that when his company weighs growth opportunities, it considers both net present value and the internal rate of return. "No one way will get you to the answer you need. You have various audiences that want to be comfortable." In addition, in an industry like energy, which is dependent on large, long-range investments, it is important to consider the potential of the investment over time. "By the same token, our investors are very concerned about earnings per share," he added. "Finally, if you put your hat on with the credit rating agencies you are looking at cash flow coverage. So you need to look at everything from a balanced perspective."

Barnes said the word "uncertainty" best describes the current financial markets. "It's a very unusual time with interest rates still low, but your equity valuations are a mixed bag depending on the industry. Most times corporate executives are bullish about their own stock, but bearish about someone else's." In today's "rocky" environment, managers are timid about going out in the financial markers. "But the best time to take action is when everybody else is not – between cycles," he said, noting that 10 years ago, most companies would have been eager to take on debt at today's interest rates.

The strength of equity markets varies by industry, Barnes added, but because many executives feel their firms are perpetually undervalued, they put off going into equity markets until there is a better time. When their stock eventually does rise, they often regret not having made the move earlier. "When you don't have to issue debt or equity is the time to do it so you are ready for future opportunities."

According to Mitch Theiss, managing director, global industries group, at Merrill Lynch, a company's growth is often determined by the stage it has reached in its lifecycle. "For companies farther along –

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steel, paper products, aluminum – growth through acquisitions and consolidation is clearly the preferred path. At earlier stages, markets expect more internal growth." He pointed to competing retailers Home Depot and Lowe's, which are building out new stores to generate growth. A third way to grow is when a company totally reorients itself. An example of this tactic is Eastman Kodak Co. "Kodak saw a decline in its film business because of digital so it recast itself significantly through acquisitions," said Theiss, adding, however, that large acquisitions are always dilutive. "Smaller acquisitions are much better received in the market in the near term."

Debt and equity markets are strong at the moment, Theiss pointed out. Interest rates are low and cash is available for high-yield and investment-grade debt. The strength of equity markets varies by industry. Commodity businesses, for example, are "hot right now."

Buzz Doherty, managing director and head of oil and gas investment banking at Barclays Capital, noted that his firm is committed to organic growth but cautioned that it is always necessary to keep an eye on costs in the investment business. "Everyone at this table recognizes it is a business that needs cost controls. It's cyclical. It depends on clients and if you don't manage your costs well, you will end up very far behind the curve in difficult markets."

In response to a question about the role of rating agencies, Doherty pointed out that his firm is part of a 300-year-old bank that has been making credit decisions long before there were rating agencies. "There's always a tension between how much you rely on what the rating agencies believe or say, versus how much your own intuition tells you. There are many other measurements that are more real-time than the rating agencies. [These agencies] do provide a set of data that a large number of investors and observers of credit tend to rely on as a starting point and a pathway forward."

The Golden Age of Private Equity?

Private equity firms, which hold $100 billion in uninvested funds, are coming into the improving economy with an appetite for large deals. In some cases, they are forging alliances to come up with enough equity to compete for promising opportunities, according to speakers on a panel titled, "Financial sponsors: Finding value in a competitive market."

Michael Movsovich, a partner in the law firm Kirkland & Ellis, suggests that the new attention to private equity has increased competition and speeded up deal making. "It used to be you had time to develop relationships. Now everything is an auction or a potential auction."

The burgeoning size of private equity deals is driving a trend toward large syndications, he said. "This is a sign of how mature the industry is and where it is going. What we have seen in these big deals is a need for capital and diversification for truly large deals." Deals today are so large they are beyond the equity capitalization that even a large, established private equity firm such as The Carlyle Group or KKR can muster.

To raise even more money, private equity firms have turned to pension funds and insurance companies, but to attract those investments, private equity funds have been forced to distinguish themselves with specialized expertise to draw investors trying to diversify their holdings into the best investments. "You have seen a stratification of the private-equity business in the last several years," said Movsovich. "In order to raise capital from pension funds and insurance funds, people have had, by necessity, to distinguish themselves and develop expertise."

When private equity firms team up, he added, many legal issues arise in structuring the arrangements. For example, firms need to consider whether it will be a 50-50 joint venture. How will the board be structured to respond to disagreements? What is the projected lifespan of the partnership?

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"Some have said we are living in the Golden Age of private equity," said Daniel A. D'Aniello, founding partner and managing director of The Carlyle Group, the Washington, D.C.-based private equity firm with more than $18 billion in funds under management. Investor disenchantment with the technology crash, combined with cheap debt, gives private equity firms power to pursue deals on their own, or in partnership with other private equity firms, that previously would have been the province of large, public funds, he suggested. "I would argue the consolidation has already taken place."

Pension funds have tried to exploit economies of scale and drive down back-office expenses by concentrating investments with fewer and fewer asset managers, he added. The winners have been firms that have invested in infrastructure. That has allowed them to perform well under the new Sarbanes-Oxley regulations. "Fiduciary issues are now preeminent – as well as economies of scale."

D'Aniello predicted the industry will develop along two lines: One to two dozen firms with global resources on one hand, and small specialized boutiques on the other. "The middle market is pretty barren especially with respect to generalists," he said. "In the early days you could get away with being a generalist. Not anymore."

D'Aniello cautioned, however, that pension funds and insurers are not too supportive of the private equity partnerships because they like to spread their investments across firms to remain diversified. When private equity firms team up, institutional positions are consolidated. "Not only that, they are being consolidated at the highest price possible."

D'Aniello forecast that financial spreads will tighten. As a result, The Carlyle Group is building in-house expertise in the industries and companies that make up its portfolio. "Carlyle is focusing on operational people rather than financial engineering. In the future, money is going to be made on the factory floor, not in the investment banking or the commercial banking office."

A Generational Shift

According to John A. Katzenberg, managing director of Citigroup's financial entrepreneurs group, strategic buyers looking to make acquisitions that will complement their existing business have been losing ground to financial buyers in recent years. At the end of the 1990s, strategic buyers using their own stock price were able to trump financial buyers in making deals. The subsequent fall-off in stock prices has now put more power in the hands of financial investors, who are benefiting from cheap and available capital. "In many transactions where there would be a strategic buyer, they are being outbid by financial buyers." Katzenberg also said regulatory requirements on financial buyers have been reduced. "They are willing to pay more and get less return."

Despite a lot of attention in the press, Katzenberg noted, hedge funds do not represent a significant amount of activity in the private equity market. Hedge funds have mostly concentrated on buying debt securities of distressed companies. Hedge funds and private equity firms each have about $1 trillion under management, "so they have equal buying power but the skill set needed to buy and invest in private equity is different than the skill set of running a hedge fund. You need infrastructure. You need people who understand an industry, can do due diligence and have deep relationships with management and investment bankers."

Jorge Mora, executive director of UBS Investment's financial sponsors group, predicted that private equity investment in Europe will outpace that in the United States in the next few years. The private equity industry is maturing but may still face some volatility ahead. "Is it here to stay? Absolutely. Is it stable and predictable? I don't think so."

Mora pointed to a generational shift that will take place in the private equity business in the next decade as big name figures in the industry, such as Henry Kravis and Tommy Lee, retire. Younger partners in

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firms may decide to spin off their own funds. "I think the people that focus on the institution being a permanent institution are going to do a lot better."

Kathryn B. Swintek, managing director and head of the leveraged finance group at BNP Paribus, noted that a major company recently said a signature deal in the early 1990s required 15% equity and returned 40%. The same size deal a year ago would have required 35% equity and returned 15%. "That leads to even more pressure to come up with the proprietary idea where you can achieve decent returns – i.e. above 25% – which is tough in an auction environment," she said. Swintek predicted a stable market for the next 6 to 12 months, but said cyclical factors may eventually lead to a downturn.

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