Private Equity — Holding Steady, Readying a Growth Stage

After a lackluster first half, private equity broke out stronger in the third quarter, fueled largely by corporate America's shedding of some large, non-core assets. Expect this trend to continue in the months ahead, with most deals in the middle market range of $50 million to $500 million. That is one of the insights to come out of a discussion between Philip Bass, global private equity markets leader at Ernst & Young LLP, and Stephen M. Sammut, a senior fellow and lecturer at Wharton, featured in this Knowledge@Wharton podcast. "Overall, the financing is there, the capital is there," says Bass. "We do need a pick-up in the overall M&A market, and if we get that pick up, we'd expect private equity pick up as well."

An edited transcript of the discussion follows.

Knowledge@Wharton: We're speaking today with Steve Sammut, a Senior Fellow and Lecturer at Wharton, and with Philip Bass, Global Private Equity Markets Leader at Ernst & Young. Our topic: How private equity (PE) might fare over the next several Quarters, and we will also be taking a look at the private equity market in emerging markets. Thank you both for joining us today.

To set the context, the value of PE deals rose slightly in the second quarter of 2012 compared with the first quarter, mostly thanks to some very large deals. But overall the trend was downward generally in the first half compared with the same period last year. What do you foresee for the industry over the next couple of quarters? Phil, maybe we can start with you.

Philip Bass: Sure. We've started out with a pretty strong July and August (most of the third quarter) fueled in large part by some of the large assets, the non-core assets that corporate America is shedding. We expect this trend to continue — that more and more of these assets, non-core assets, will come to market. At the same time, we still expect most of the deals to be in the middle market range — so $50 million to $500 million deal value. Overall, the financing is there and the capital is there. We do need a pick up in the overall M&A market, and if we get that pick up we'd expect private equity pick up as well.

Stephen M. Sammut: Those are very important points. And as you started out saying, the overall trend for the first two quarters of the year was not looking promising, both in terms of the number of deals and the overall amount of capital expended had actually been part of the continuing downward trend. It is, in fact, encouraging to hear that July and August are on the up-tick. And I agree that many corporations are refocusing and rationalizing their business activity, thus bringing more opportunities to market for the private equity funds. I think the analysis that we are looking at — a market that favors more mid-cap or middle market type acquisitions, and in those price ranges — is spot on. In fact, when you look at fund raising trends, there does seem to be some favor, and there has been some favor, with money flowing to middle market funds as opposed to the mega and large cap funds.

Knowledge@Wharton: Phil, if you were to look out over the next year or two what do you see as most likely to happen?

Bass: Well, I think we're optimistic on private equity. Again private equity does have capital. Fund raising, while taking longer, is happening. So the funds with the better history and the performance are able to raise funds, and are able to raise funds of size. We do think that the capital will be there and overall we think the financing market will continue to be there. What used to be an LBO-type market — or a leveraged loan market — really has transitioned to a high yield bond market, which continues to be a big part. We're optimistic on the role of private equity. We're optimistic globally as more and more of the PE firms diversify around the world to take advantage of some of the higher GDP growth markets.

Knowledge@Wharton: Steve, what is your view over the next year or two?

Sammut: I'm generally very positive as well. You know the old saying — it's difficult to make predictions, especially about the future — holds true here. But certainly the conditions line up for a very promising situation. There's still a capital overhang. But it is diminishing. There's a large inventory of portfolio companies which need to be divested. So there does need to be an infusion of liquidity into this asset class. It's not likely to come from IPOs. But there may be more trade sales and acquisitions by strategics going forward. If that happens in combination with the other factors, I think we are going to, at least in the U.S., be looking at a very promising future. Just another comment — capital is being raised. There was a very interesting article in the *Wall Street Journal* just last week dividing the universe of private equity funds into the haves and have nots — those funds, basically with strong histories, being able to raise capital and those funds with less attractive returns — struggling. In fact, many of them [are] delaying going to market formally to raise capital just to avoid the impression that they're over-shopping themselves.

Knowledge@Wharton: Private equity — more generally — surprised many observers with its recovery since 2008. There was this famous "wall of debt" that was overhanging the market and it worried analysts a lot but it turns out it's been mostly refinanced thanks to the low interest rate environment. Are private equity firms over that hump now for good? And also how would they fare if there were to be a global spike, say from the fallout from the situation in Europe, for example?

Bass: Well I guess a couple different things. The first is, I think private equity's worked very hard through the recovery. Not only did they refinance their debt, but they really worked hand in hand with their portfolio companies to improve their operations. Overall the financial performance and operations of the portfolio companies have improved.

Additionally, I would say — again getting back to the wall of maturity — private equity has been very focused on improving the debt and capital structure of their investments. And when we look at that wall of maturity today it really is out to 2016 so it really has been worked off. The next year that is particularly large seems to be 2016, which is a long time away and gives plenty of time for both cash flow generation to de-leverage as well as refinancing. So I think that wall is pushed off.

When we look at the overall debt market and we look at the future, while a crisis surely could impact the high yield market for example, and really sideline it for a while , we are very optimistic that it is resilient and will come back. And again as I said earlier, the high yield bond market has been the driver and has been the large share of the leverage debt market. And while average loan volume is fairly strong, it's really that high yield bond volume that's really greater than any year in history.

So we are — with investors' uncertainties from any other asset classes and the solid performance of leveraged debt — we do see continued flow of leverage — a high yield of leverage that continues to drive a greater supply of funds into the market. So overall we do think that will be there. We think there could be blips in the market. But overall, long term, we think that the financing is there to help to really drive activity and private equity.

Sammut: I would agree with that assessment for all the reasons stated. I'd want to emphasize a couple of other things. And that is, relative to other asset classes, while this is not the only game in town it's certainly one that provides shelter and the possibility of robust returns in ways that other investments cannot. There are very few places to really get acceptable returns or yields these days. And the way that the private equity industry has managed itself is, I think, helpful for many investors. There's one other point worth emphasizing. And that is there has been a shift in the style of American funds to emphasize more operational improvements and expansion of companies as entities. And while financial engineering has not been de-emphasized, there really has been a new emphasis on the performance of the portfolio companies. The combination of those two things is very powerful. And I think we'll give the private equity funds a real staying power in the market.

Knowledge@Wharton: Emerging markets — turning to another topic — have often been cited as a key growth opportunity for private equity. But lately China, India, Brazil and others have been slowing down quite a bit. Will this change private equity's view, at least in the short term?

Sammut: That's an interesting question. According to the Emerging Market Private Equity Association, the numbers that I looked at basically across the board, fund-raising so far in 2012 is down compared to previous years, particularly in the big markets that you've described. And there probably has been concern among many investors that particularly Brazil, but to the same extent China and India, has been over capitalized. I don't know if that's true. There may be some other concerns as to why opportunities aren't coming to market as quickly there. But the macro factor is this: in the aggregate the emerging markets represent about 15% of all of private equity on a global basis. There's a huge amount of room for growth. And even if it doesn't occur in 2012, the trend over the intermediate term is probably going to be for it to become a greater percentage of an expanding pie, at least in my view. So there will be a great deal of promise.

If China's economy beneath the sheets is struggling to the degree that some people are speculating, that's actually going to create a lot of opportunity for restructuring and for buy-out opportunities. So we'll see what happens.

Knowledge@Wharton: It may just be that the kinds of opportunities that become available change as you say. Restructuring would be one good example of that.

Sammut: I think so.

Bass: But when you put the slowdown in perspective, when we really look at markets like China and Brazil and the decrease, the deceleration of the economy and GDP growth, still, in many cases the GDP growth this year as well as long term is expected to be greater than the more mature markets like the U.S. and Europe. So again, as Steve said, the long-term fundamentals are strong, and continue to have regulatory support. You've got a strong entrepreneurial culture, rising middle classes and probably, most importantly, you've got this low private equity penetration as percentage of GDP growth. So we continue to see opportunities across the emerging markets for long term growth. There surely will be some struggles, ups and downs in the short term. But I think the long term fundamentals continue to be there.

Knowledge@Wharton: If private equity in these emerging markets is about 15% of the total globally right now. Where do you think it will be in three years?

Sammut: In three years we may be looking at 20% of, as I put it earlier, a larger pie. It could be even greater than that, especially if some of the frontier markets continue to accelerate the way that they have been.

Bass: I agree. There's been a report put out by the Emerging Market Private Equity Association (EMPEA) that surveys LPs [limited partners] and really supports the 20% — so an increase from 15% to 20%. Emerging markets and the frontier markets together will continue to be an opportunity to diversify to get some of the higher returns, along with the higher growth rates. The expectation is higher returns along with the managed risk profiles. So I think they'll continue to increase and continue to be a bigger part of the overall pie.

Knowledge@Wharton: Since a lot of those emerging markets and frontier markets are in Asia, let me ask you a question more directly about China, where a company called Hony Capital is now the biggest PE firm in Asia, with a five-year fund raising total of $6 billion. What's that say about the changing face of private equity in Asia?

Bass: Well, I think it speaks to the institution of the asset class across Asia and really the other emerging markets as well. There are other private equity firms — CDH, Gavia — that also are increasing in size in their own markets. And the trend we're going to see with that institutionalization is that these funds begin investing outside of their home markets. So I think we're seeing the institutionalization of the asset class. And that's a good thing for private equity. And it's a continuing trend.

Sammut: That's very consistent with what my thinking is. And right now we tend to be a little China-focused. But at the same time, the institutionalization of this asset class in the Middle East has actually increased as well. And the ascendancy of a barrage out of Dubai and their activity now, which is extending even beyond MENA Region — Middle East North Africa — I think really is suggestive of how it will be. It won't be just the KKRs and the Carlyles and the Blackstones doing deals on a global basis. I believe we're going to be seeing global activity emerge from the larger funds in what we now call the emerging markets.

Knowledge@Wharton: Thank you both very much.