Watch for Private Equity in 2013 to Mirror 2012

Private Equity held its own during 2012 in a volatile year for the world economy. Funding for the industry was up slightly, while the number of actual deals dropped a bit below 2011 levels and exits were down. With merger and acquisition activity down, there were fewer assets available. To gain more insight into how private equity performed last year, Knowledge@Wharton spoke in this podcast with Philip Bass, global private equity markets leader at Ernst & Young, and Pavel G. Savor, a Wharton Finance professor. An edited transcript follows the audio file.

Knowledge@Wharton: Hello. We're speaking today about private equity's performance in 2012 with Pavel G. Savor, a Wharton Finance professor, and with Philip Bass, who is the global private equity markets leader at Ernst & Young. Thank you both for joining us today. Philip, let's start with you. Last year was a bit of a mixed year for private equity (PE). Fundraising was up, but IPOs were down. Here are a few of the headline numbers: announced deals on volume — down about 6%; announced value — down about 9.5%. PE backed IPOs were down by almost half — by a dollar value. Would you discuss that? What are the themes? What were the reasons for that?

Philip Bass: Yes, but I would take a slightly more positive look. I think PE did a pretty good job this year. Overall, it was stable to good, especially given the volatility that we had in the overall macroeconomic environment, clearly a tough market to work in. At the same time, overall M&A (mergers and acquisition) activity was down. When you look at the overall M&A activity, [there were] fewer assets available. At the end of the day, when you look at some of the numbers, PE did pretty well.

Fundraising was up [slightly, with the full-year's figures], private equity [deals] were clearly slightly down and exits were down. But at the same time when you look at the overall exits, IPOs were about flat and, clearly, in the U.S. IPOs were up. So there were some bright spots. Overall, I think private equity is positioned to have a good year ahead if they are opportunistic and take advantage of the opportunities that come to the market. But ultimately they need assets. They need more assets available out on the street.

Knowledge@Wharton: Pavel, could you offer your view please?

Pavel G. Savor: Well, I would mainly echo Philip. I thought it was an okay year, probably a good year. The reason people may be slightly disappointed is more that the big years of the quote, unquote golden age of private equity were just so much better. But at the same time, I don't think anyone believes those days are coming back any time soon.

Fundraising was reasonably steady and probably up. And that's a measure of future activity in PE. Deal volumes were down somewhat. But, as Philip said, that it's probably [brought on] not by any key specific issues, but more [about] the macroeconomic environment, which was volatile. So I think PE had a decent year. To the extent that someone is hoping for a much better year, I think that may be partly an issue that at least some big PE firms were staffed up and prepared for a different world before the crisis, and then they'd be hoping for that world to come back. I think that is not happening again, at least not in some reasonable future. But otherwise I thought it was a good year.

It's hard to expect that PE IPOs would explode when the overall level of IPO activity is flat to down. So in some ways PE, as any other long-only asset manager, is at the mercy of what's happening in the wider economy and the markets. So if you think those are going to do much better in 2013, PEs going to do much better. And if you're, as I am, all a bit less optimistic, then you would expect 2013 to not be too different from 2012.

Knowledge@Wharton: The number of exits for IPOs and the number of M&A deals declined in 2012 in dollar terms — maybe by the number of deals not so much. But the deals that floated, however, appeared to have performed well. Could you comment on that? Because what you've said so far, I think, is that this is a bit of a relative case where, given what's happening in the economy and the other markets, private equity has performed relatively decently.

Bass: You're right. There clearly were lower volumes of IPOs. But when you take a look at after-market returns, on a market-weighted average basis, then PE IPOs on average increased 11% their first day as a public company. But more importantly, the majority of these companies held onto those initial gains and through close to the end of the year, there was about a 14% return above and beyond the offer price, the initial price they went out at. So overall they've been performing well in the market. And when you look out into 2013, there are 57 or so private equity companies still in the pipeline — $11.8 billion in value ultimately making up about 10% of the IPO pipeline.

So IPOs will continue to be something that private equity looks at. It's a very viable and a strong exit choice, depending upon the kind of company. But the key is going to be patience and flexibility because, as the professor said, — it truly doesn't look like 2013 will be much different than 2012. There will continue to be volatility in the market and that will translate into volatility in the IPO market as well. So private equity will open and shut during the year. And during the time periods that it's open, there will be private equity IPO activity.

Knowledge@Wharton: Pavel, do you tend to agree with those views?

Savor: Yes. And what we saw in 2012 is not too different from what researchers have documented over the years. PE-backed IPOs, and here I am distinguishing all of this from venture capital, tend to do reasonably well unless they are quick flips, i.e., when PE firms very quickly sell IPO stakes they've only recently bought, otherwise they tend to do well. There are a number of explanations for this that people have offered. So 2012, in that way, is no anomaly.

Now in terms of future IPOs, given the size of some of the key deals, especially the ones that are remaining from the past years, IPOs in some way seem to be almost the only viable exit given the size of these businesses. Very few strategic buyers are out there. Given the size, it's hard to sell to other PE firms at the price that sponsors find attractive. So they will have to tap the IPO market, which is notoriously volatile and very quickly, especially if there's volatility, tends to almost shut down. So PE firms will have to be very opportunistic in trying to take advantage of any windows that open, especially given the old deals that they still have not exited — their LPs [limited partners] are pretty eager to monetize those stakes and move on.

Knowledge@Wharton: Philip, a recent Ernst & Young report on private equity notes, especially at the largest firms, that PE firms are continuing to diversify into new lines of business. And that's blurring the line between PE and asset managers. Can you discuss this trend, and whether it is coming about by necessity — or is it a natural evolution of the PE industry?

Bass: Our view is that it's a natural evolution of the industry and that it's coming about to diversify your earning streams. So when you look at the bigger firms, private equity is still a big part of the business — but you'll see that at the bigger firms at the public private equity managers, they're really getting into hedge funds, venture, distressed debt, fund-of-funds, advisory, a number of different businesses. And ultimately private equity (i.e., buyout) ends up being in that — 25% to 50 % of their assets under management. So it's a way to diversify their earning streams without relying wholly upon private equity, which as we know, depends, the exit environment to trigger the returns. And therefore some of the alternative asset classes provide more stable and consistent earnings to offset some of the volatility in the private equity asset class.

Clearly, at the larger private equity and the public PE firms we see that trend. We think that that's also beginning to happen in the middle market. We're seeing how the middle market firms, get into debt, into venture capital, and real estate, where they haven't historically gotten into some of those asset classes. And I think it's not as much about coming about by necessity, it's really around opportunity and being opportunistic in the market, and taking advantage of the skill set they have as an active asset manager — taking the expertise they have in private equity — but also bringing in other resources and applying that expertise to the other asset classes.

Knowledge@Wharton: The report mentioned increasing interest in "separate" accounts for some large LPs. Could you explain what that concept involves?

Bass: Separate accounts are well established in the traditional asset management state and asset management space. [They] give large LPs, large investors, more control over their investments. It ends up being a more customized solution to meet their investment needs. So this can better integrate and align investments with the LP's overall portfolio objectives, and at the same time provide larger pools of capital to the GPs [general partners] than they might otherwise have access to. It's an arrangement agreed upon between the GP and the LP for the LP to participate in ways beyond the more traditional way that they historically have, investing both, side by side with their more traditional investment.

Knowledge@Wharton: Pavel, tech plays have been down, while consumer plays have been up over the year. Could you discuss the reasons that that might be the case?

Savor: I think the consumer sector performed reasonably well in 2012 and that probably explains mostly why we saw this trend. I also think the 2011 numbers may have been slightly skewed by the Skype deal, which was a great exit for PE. But it's hard to think that the industry that PE firms work with would not change over time — it's driven largely by what's happening overall in the markets and in the economy.... So if they see opportunities in the consumer retail space, they'll quickly jump in because those may disappear and they may think that tech, which is at least for some firms is reasonably priced, is not something where they can earn adequate returns for their LPs.

Generally the tech space has really only been explored by PE firms as separate from VC. In the first decade of this century, they stayed away because they thought the pricing wasn't right and that these firms are harder to lever up. Now that has changed, but it's still the case that tech companies tend to be more richly valued than other businesses. And that may just make it harder, especially at times when pricing is not depressed for PE firms to earn adequate returns.

Knowledge@Wharton: In emerging markets, overall, fundraising was down a little bit, but most observers seemed to be continually bullish on them when it comes to PE and many other things for that matter. Is this simply a period of stabilization now Philip?

Bass: Emerging markets go up and down. The amount of activity in any individual market tends to be driven in any given year by whether there were a handful of large transactions. I think saying that, emerging markets are here to stay. There's more capital available in the emerging markets than ever before. What really was a focus on the BRICs is now expanding beyond the BRICs into the frontier markets. So when you take a look, for example, at Latin America, surely Brazil is the big market and quite a bit of focus is there and will continue to be there. But Colombia, Peru, Chile and Mexico are getting quite a bit of attention.

So at the end of the day I think that there will continue to be a lot of focus on the emerging markets, and the story that we've talked about before hasn't changed — it's around higher GDP growth than the more mature markets. [And while] GDP growth dropped in many of those [emerging] markets this year, they were still higher than the mature markets like the U.S. and Europe, and are expected to rise over the next couple of years.

So that's the starting point. But then you factor in a number of other considerations — low private equity penetrations, lack of financing generally in the market, lack of a strong venture capital market — ultimately the combination of all those is a need for capital. And then you combine that with the rising middle class and increased consumerism, and we think, long term, private equity will continue to look at the emerging markets as a great investing opportunity.

Knowledge@Wharton: Pavel?

Savor: Well, I think no one would dispute the fact that now and going forward the emerging markets are going to become much more important economically, in general, and probably for PE as well, just as a result of that. So over time they'll become bigger, probably relative to the size of the economy, there'll be more PE activity — those two combined to give you an optimistic view of PE in the emerging markets.

Now a more relevant discussion I think is, at least for PE firms operating out of the U.S., is, will they be the ones to benefit from this. And that is a much more of an open question. I know we'll talk about China in a second, so I guess I can talk about China a little bit. There were some tremendously successful PE deals for a few select U.S.-based PE firms. But apart from that I think it's been a reasonably hard market to penetrate.

And if you think about it, it's not immediately obvious why, for example, Blackstone, and I'm just using it as an example, would be the biggest beneficiary of growth in China and growth in PE activity in China. China is capital rich. Its big banks tend to lend to insiders, which Blackstone still is not. It's a somewhat regulated country where regulations get enforced selectively. Local firms may be better positioned to operate in that environment than Blackstone.

So, I'm very optimistic about PE activity overall in emerging markets. I'm a little bit less optimistic about how successful large U.S. and Europe-based PE firms will be in taking wide advantage of opportunities there. They may occasionally be invited to participate in deals, especially in flagship deals. But after local competitors develop, they may be ultimately better placed to benefit from growth in those markets.

Knowledge@Wharton: Philip, I'd like to get your view also [on China] and just to provide a little bit of context, the data shows that domestic IPOs in the first 11 months of 2012 at least, raised only about half of what was raised in 2011. Again, I take your point that sometimes big deals skew the numbers and maybe that's what happened. But I also noticed something in the press that there's something like 800 firms waiting for approval in China to list as an IPO in the domestic Chinese market. And now it looks like China is at least talking about relaxing some of the regulations there that could allow more companies to get involved in PE listings outside of the country. Would you discuss China's performance over 2012 and also what you make of this new relaxing of the regulation that's being talked about?

Bass: You've touched on a couple key points. One, the regulatory environment hasn't been the friendliest in China. But at the same time, I think it's also been impacted by the greater macroeconomic environment as well. China's been impacted in the IPO market and again we know China-focused IPOs haven't fared that well in the U.S. exchanges either. [Regarding] regulatory environment developments in the region, there looks to be some encouraging news in that area. And it looks like some new regulations are going to be instituted pretty rapidly that help deal with the 800 firms waiting for approval [for pending IPOs] and really open up the market.

We did a recent survey, capital confidence barometer [the Ernst & Young Global PE Capital Confidence Barometer], where we polled over 100 private equity professionals globally from around the world. And I can tell you that the feedback was emerging that Asia and China clearly are at the top of the list for investing activity. So, clearly, exits have been a challenge. Clearly it's a tough area. But at the same time, China's a big market, we'd expect private equity to continue to play in [it], and certainly the survey results really support the fact that private equity and China will work together to figure it out.

Knowledge@Wharton: On to India – one of the BRICs and it was the fastest growing PE market in Asia in 2011. But as I understand it there were some important changes in regulations and perhaps other areas that have slowed momentum. Could you discuss the main themes in India's PE market in 2012?

Savor: So I'll start off with saying that I am less familiar with India than China. So India has a much longer standing tradition with capital markets than China. And it has a reasonably active stock market, that's been there for a long while and the PE firms have been there longer than in China. I would say that so far it has been an okay experience for them, not tremendously successful. They have many regulations that make it harder for PE firms to operate there. And there have been some issues with taxation where the Indian government has basically tried to change rules for investors retroactively and that type of policy uncertainty is really scaring away PE firms.

So it's hard for me to make definite statements about the future. I guess it's always impossible, but PE firms will definitely keep entering India. I know of a few that have moved their main offices to India. But I think it's a hard country to crack. It's still, especially on the capital markets front, subject to many regulations. It's dominated by a few banks that have not as of yet been open to working on PE-type deals with a lot of leverage as in some other markets. But on the other hand it's a quickly growing economy where population growth is still high, unlike in China where the consumer sector is really not developed and where the government is continuously making noises about deregulating these sectors of the economy.

Now we've seen they made noises about this but it hasn't happened so far, so it's hard to predict the future. But if you see significant reforms easing the entry of foreign investors into India, I think the infrastructure is there and these guys are really ready to jump in. And if those changes happen, you could quickly see a huge ramp up, I think, in PE activity in India. Probably more so, in my opinion, than in China which is still very insider-oriented.

Bass: I think Pavel covered it well. I think even with the complexity of doing business in India at times, the activity was stable this past year compared to the prior year. So, overall results on activity really weren't down. And we also saw an uptick in the larger deals. So clearly it continues to be a large area of interest for private equity investing.

Pavel touched on the population. GDP growth is expected to be at 5% and continue to be stronger than the more mature markets. So we look at India as a market where private equity is going to invest, and in our recent survey, 69% (of respondents) indicated it was the fourth-most attractive destination for emerging market investing with China, greater Latin America and Brazil ahead of it. But at the same time, [it is] still very much up on the radar and still very much a large area of investing for private equity.

Knowledge@Wharton: We've been speaking with Philip Bass from Ernst & Young, and Wharton professor Pavel Savor. Watch for our podcast next quarter. Meanwhile, you can access past podcasts plus additional insights into private equity at our website. The address is: kw.wharton.upenn.edu/private-equity.