Private Equity Expects Better Times in 2014

Key signs point to a pickup in private equity (PE) activity in 2014 and optimism is running strong, according to a survey of 100 PE firms and 1,600 corporations by EY and the Economist Intelligence Unit. Some reasons for the optimism: The world economy is forecast to grow faster -- by about a half of a percentage point over 2013, many economic forecasters say; there is plenty of cash available for deals; and the number of mergers and acquisitions – which often stoke PE activity -- is expected to rise. What's more, investor interest in BRICS countries and emerging markets also is increasing. To learn more, Knowledge@Wharton interviewed Michael Rogers, EY's global deputy sector leader for private equity, and Stephen M. Sammut, a senior fellow and lecturer at Wharton, for this podcast. An edited transcript of the conversation appears below.

Knowledge@Wharton: Today we're going to discuss the outlook for private equity in 2014 with Mike Rogers, who's EY's global deputy sector leader for private equity, and Stephen M. Sammut, a senior fellow and lecturer here at Wharton. Thank you both for helping us to look into the crystal ball for the New Year.

Let's get right to it. Private equity (PE) appears to be in an interesting place as 2014 opens. A recent survey, done jointly by EY and The Economist Intelligence Unit, shows that there's a lot of market optimism, both for PE and for the global economy more generally. That survey polled about 100 private equity investors, along with an additional 1,600 corporations, so it's a pretty big survey.

Today, PE firms have plenty of cash -- so do corporations -- and the corporations are increasingly eyeing M&A activity. So that means the number of deals are probably going to increase. Would you both offer your view on the macro situation for PE for 2014?

Michael Rogers: Our reaction to the study, and what we're hearing anecdotally in visiting with our clients, is that PE firms are much more optimistic than they had been about the prospects for the industry and the global economy. That's the good news -- a good sign for the market in general. They expect an up-tick in not only the global economy, but in fundraising and exit activity as well. Some of that is buoyed by emerging markets but I think, more importantly, it's just stabilization of the U.S. economy given the heavy weighting that PE has within North America.

If we could keep away from the exogenous variables that seem to crop up every three or six months, be it budget issues or other tapering concerns, we feel that 2014 could be a very good year. We have to, of course, watch out for the economic volatility. And of course this recovery has been very slow and unsteady. We expect additional shocks to the system from time to time. But we're hopeful that if those things aren't too terribly concerning then we could get a nice improvement here.

And lastly, there's a nice position in dry powder out there that should allow for deals to get done. And hopefully the exit market will improve more for the funds as well, which just continues to improve the velocity and the frequency of transactions, which is good, in terms of gaining liquidity in the marketplace.

Knowledge@Wharton: Was the survey fine-tuned enough to suggest by what percentage you think the market will increase in the coming year? People are positive, so you think it's going to go up by how much?

Rogers: We don't ask if it going to go up by what percentages, but 66% say the global economy is improving. Fifty-two percent of the respondents from the survey consider political instability to be one of their major concerns. And there's a couple of other key statistics in there. Seventy-one percent are raising new funds. Fifty-three percent are concerned about quality of assets and some other issues out there.

But a big number are looking to move into emerging markets. And there is a higher propensity to do these transactions. More people think they're going to transact in 2014 as a result of this survey.

Knowledge@Wharton: Steve, what's your experience as you talk with people around the world?

Sammut: Macro surveys always intrigue me for a variety of reasons. While it is very true that private equity professionals are keen observers of what's going on and are very sensitive to macro economic factors, oftentimes when they are asked a question like this they're drawing upon personal observations and anecdotal data. So I think the most we can say is that the attitude is positive and that most people are expecting that things are going to be better than they have been the last few years, and that's a good sign.

Private equity does move on the fundamentals. The devil is in the details of all these transactions. What it really comes down to with respect to the macro issues -- especially for the people in leveraged buyouts, which is less of an issue for the emerging markets -- is what is going to be the supply and cost of capital out there for purposes of leveraging? In other words, do the macro fundamentals lead up to there being a robust credit market? And there seems to be an impression among just about everyone I've spoken with that capital will be available this year. And I think that's what's driving the optimism.

Knowledge@Wharton: So the PE firms themselves have a lot of cash. Corporations more generally have a lot of cash, so that's a big part of this equation, isn't it?

Sammut: Yes it is. And that is good news for entrepreneurs and owners that are seeking liquidity or growth capital for their enterprises. From a competitive point of view, among the private equity firms, it's probably not such good news because whenever this has happened historically prices have gotten bid up pretty substantially. And that can have a chilling effect on activity.

Knowledge@Wharton: So, if you're a private equity company you want things to be a little bit positive, but not too positive when it comes from the cash point of view?

Sammut: Yes, you don't want all of your colleagues and competitors to have enough cash to make your own bid and the responding ask out of whack.

Knowledge@Wharton: In a global market where conditions overall appear to be more favorable for PE, there's still a trend by almost a third of PE firms surveyed towards extending the investing and holding periods of their portfolio companies, while the PE firms work to squeeze out more efficiencies. And this has been going on since the financial crisis when things were really tight and they focused more on making their portfolio companies more efficient. Why do you think that number is still pretty high five years later? And when do you think these kinds of extensions will no longer be needed?

Rogers: I think certainly during the slowdown the ability for folks to do some operational improvements or value creation activities and then monetize those through exit really slowed down quite a bit. In fact, another survey that the firm released is our exit study in North America. It shows that on average, typically, we had had hold periods in the 3.5-year range. And that had grown out to 5.1 years on average. So you could imagine if it's a 5.1 year average, you've got some names in your portfolio, investee companies that might have been there six, seven, eight years.

And so that's well beyond the norm for private equity as was discussed earlier in terms of people looking for natural liquidity.

So that problem has been exacerbated the last few years. And part of our research shows that 30% of all GPs (general partners) have been approached by LPs (limited partners), or they have approached their LPs about extending the time horizon of these funds. As you know, most of them have time horizons and the LPs eventually want their money back. And so 30% of those have had to go out and say, "Hey, how about a few more years because we just haven't been able to achieve the things we want with the business and then allow us to monetize it."

And it just shows how difficult it's been for PE firms to grow these portfolio companies and exit them in the aftermath of the credit crunch, which was just discussed, and also the economic slowdown. I think the effect of the crisis is behind us, for the most part. But this ongoing slow growth model is not really helping funds position their investments to look favorable to the outside market.

If you're obviously trying to hit the IPO, you need a little bit of sizzle in that company's growth and operating performance. It can't be all cost cutting. They have to show some growth. And so it's been such a low-growth environment where the top line has been tough to come by, it makes it very, very difficult to make it appear that this is an attractive investment for either a secondary sale or an IPO.

In fact, exits are down on a year-today basis about 7%. Volume is down about 6% from last year. So they have announced almost 800 exits in the private equity space, but again, showing just a downward trend there, which we would have expected as you point out, that at this point in the cycle we would be seeing a lot more exits in the marketplace. In fact we think there's just a huge pent up overhang of companies that need to come to market.

In answering the first part of your first question -- what do we expect in 2014, I think a lot of this is just driven by the fact that we see the exit market improving and we see a couple of systemic issues that have been in the way, such as the China IPO market stoppage essentially. And some of those things are turning around and improving. The IPO market certainly in North America is very strong. If China could open back up we'd see, I think, more and more exits on a global stage.

Knowledge@Wharton: Steve, do you generally agree with that view?

Sammut: There isn't a whole lot to add. But the China piece, which I was going to bring up, is an important one because China has been the beneficiary of very significant private equity investing, both before and since the financial crisis. And the market, the IPO market has been closed for, 14 or 15 months at this point. Now, the timing of this conversation with respect to China is very interesting because the CSRC (China Securities Regulatory Commission) has basically reopened the market. That, at least as far as China is concerned, probably allows for a fair number of issues. And it may well be enough to bring things back to where they were in 2012, not by the end of this year, but certainly that will give a boost to 2014 numbers significantly.

But one of the lessons learned from what's happened over the last few years with respect to adding value to companies -- and the survey hinted at this -- and that is that one of the buzz words in private equity has become "performance acceleration." Many of the funds, particularly the large ones now have entire teams of people whose principle responsibility is performance acceleration. This was prompted in many ways by the inability of funds to liquidate their positions, and realizing they had to do much, much more in order to move the managements of these companies more robustly towards exit opportunities or towards positioning themselves for exit.

So I think, in combination with what Mike had to say, the way the funds are behaving and operating themselves are something we have to take into account.

Knowledge@Wharton: Let's move on a bit to another in the EY/EIU survey which found that BRICS countries remain front and center for PE investors. Perhaps that generally is not surprising, although in economic terms the BRICS have sort of slowed down their rate of growth or relative growth to developing countries over the last half year or so. Realizing that each country is unique so it's difficult to generalize, what opportunities do the BRICS offer in 2014 and what's the quality of their assets?

Sammut: For two reasons I think this is a very important question. One is, in the time period leading up to the financial crisis there was in most of the markets that we're talking about a huge amount of competition for deals and a growing capital overhang which still exists. And it is fair to ask whether or not firms were making investments that perhaps they ought not to have, or perhaps did pay more than they should have for the companies. So there's a real question as to what the quality of the portfolio companies happens to be.

I'm speculating that we may see another dose of that over the year to come. And I have to question what the real strength of the potential portfolio companies happens to be right now, because many of the companies, as Mike alluded, are still operating in a relatively slow economic period or low-growth period, and have not had the chance to strengthen themselves or take command of their markets the way that they could have. So some of these companies will look like attractive places to put money, especially for growth purposes, but I think it's a real open question as to what the underlying characteristics of these companies are and how suitable they are for acquisition.

Rogers: I think there's some nice points laid out there in terms of the BRICS, the opportunity and the challenges that are out there. In fact we were in Shanghai last week (in December) for five or six days and beyond sort of struggling with the air quality that was very volatile at times we learned a lot about what's going on over there. And in terms of the investment into those markets and the interest in China, it's still very, very high.

We chatted about the opening of the IPO market there as being a critical next step because obviously private equity does not want to put money into a market that it has difficulty turning into liquidity at some point. And so the opening of that market is very, very important. It does have to do with making sure that the data and the quality of the numbers is very solid, or else that will really have an impact over time on folks' interest in investment there.

But our surveys continue to show strong investment in the BRICS. In fact, almost half the funds report a greater focus on investing in emerging markets over the last 12 months. And those countries are attracting more and more interest from GPs than non-BRICS. There are couple that rise up to the top. Brazil is still an attractive market. India also shows as a strong market, although some folks have cited the difficulty of doing business there as maybe holding that back a little bit from an operating perspective. The growth in China seems to still be there. We spoke to a number of economists when we were in Shanghai, and people feel that the growth will settle down, but that somewhere in the 7% range is certainly manageable and that's something that the government and the entities there seem to be able to support.

It really speaks to the fact that, again, almost half our LPs say that they want to diversify their investments across products and geographies. That's critical, they want to have their investments spread out. And a number of folks continue moving into these emerging markets with a particular focus on the BRICS.

Stephen touched on the fact that there's a growth challenge as we've alluded to. And in theory there should be some higher-growth pockets, markets that could be exploited and built out over time. So, I think as some of the funds look at their slower domestic growth rates in the, U.S., they are looking abroad and seeing some very attractive markets to move into.

I would add on top of the BRICS we continue to hear a lot of interest in Mexico, and Colombia, and now we're hearing more and more interest in Africa from our private equity friends, some of whom have opened up offices there to physically be on the ground and try and make investments in those markets. But clearly some of the BRICS continue to show up as the key places where folks want to grow their businesses.