Private Equity Finally Sees Stronger IPO Market

The recent successful showing for many initial public offerings (IPOs) is largely buoyed by strong equity markets. But the results also reflect smaller tranches, along with longer-term operational improvements in the portfolio companies by private equity (PE) issuers, which have been spending far more resources on management improvements than in the past, say experts at Wharton and EY. In Part I of this two-part Knowledge@Wharton podcast, Stephen M. Sammut, a senior fellow and lecturer at Wharton, and Michael Rogers, EY's global deputy private equity leader, discuss these ideas. They also look at PE growth in Africa, a trend by limited partners to place more money in larger PE funds, rising demands for fee breaks and the lift in fundraising coming from pension funds.

An edited transcript of the podcast follows:

Knowledge@Wharton: I want to welcome two experts on private equity to Knowledge@Wharton today, Stephen Sammut, who's a senior fellow and lecturer here at Wharton, and Michael Rogers, who is EY's global deputy private equity leader. We're going to talk about a number of topics around the state of play in private equity (PE), including the outlook for IPOs this year, fundraising and mergers and acquisitions. Thank you both for being with us today at Knowledge@Wharton, and I'd like to start out our discussion with the following question:

PE firms have wanted to reduce their portfolio company holding since the financial crisis began. Markets were unfavorable for a long time, but now they're turned around a bit and recent EY research shows, for example, that PE-backed IPOs had a record year in 2013 and raised more than $58 billion, or double the amount raised in 2012. All told, there were 187 PE-backed IPOs last year, compared with 110 in 2012. This year also looks strong so far, at least the first couple of months of 2014. Please comment on the outlook for the balance of 2014, and also for the next couple of years.

Michael Rogers: I think the results that you pointed out really speak to a strong year that was held last year in terms of IPOs, and the activities continued into the first quarter. In fact, March proceeds are up 143% against last year and volumes are up 46% against last year, so it's moved into the first quarter here clearly, as well. Markets, as you know, like stocks to be rising for IPO market health, and also, they like low volatility.

And we've generally had that, up until — a little bit of volatility around after the first of the year here, but generally, it's been a smooth, upward curve. In those kinds of markets, that's going to attract a lot of volume for private equity to issue IPOs. In fact, given the huge backlog of entities that they have to exit — our research shows, on average, portfolio holding periods moved out from three and a half years to over five years now.

There's a lot of company in the queue for exit, and the IPO markets are holding up very strongly. We expect this window to last throughout 2014, and we would expect the valuations to remain pretty healthy.

Stephen M. Sammut: As long as the capital markets and the overall market remain healthy, there will be demand for IPOs. The 2013 data is all the more impressive when you factor in that the Chinese IPO market was shut down, so that was not contributing to the numbers — the government basically wanted to give the IPO market a breather. It's now reopened and there are, I believe, some 700-plus companies in the queue for IPO, which is just an unfathomable number of new offerings.

I suspect that there are a couple of other drivers here that don't get discussed that often, and that is that many of the underwriters are expecting that the private equity funds or the venture capital funds will participate in the IPO. This is somewhat unprecedented, and it's adding a lot of strength to the offerings and a lot of confidence for the public buyers and even institutional buyers to know that the investors are still in for the long haul. It raises the question as to how much liquidity for the private equity funds these IPOs truly represent. But, nevertheless, it is a way of bringing cash into the companies to fuel their growth, and that is very positive. I suspect things will continue for at least another quarter.

Rogers: I think we've seen a number of our funds that we work with that have had successful IPOs. They've issued a small tranche, if you will, of their own, private ownership, and then they've played in the secondary market, six, 12, 24 months afterwards, after they've allowed the stock to run up a little bit. So, it's been great support. They haven't just dumped it all in the marketplace, and it sets a nice track record for others to follow.

Sammut: That's right. And in terms of building confidence, as I had said, among the buyers of these issues, that really speaks volumes. There was a long tradition of PE and VC firms bellying out as soon as they could after an IPO, and that game seems to be over, and it is adding to the integrity and strength of the markets going forward.

Rogers: They spent more time with these companies. They invested more time, they were more engaged, and they probably helped run them in a more intimate way, so they see the value more.

Sammut: I think that's a fair interpretation, that the company, the private equity firms, have more confidence in their own portfolios, but this is also driven by necessity. It's what the underwriters are looking for, and in many cases, the floats post-IPO are not sufficient enough to sell off the position's wholesale, so they do have to take a couple of years thereafter.

And in many instances, the lock up periods, and if when we're talking about emerging markets, the lock up periods are far longer than the six months that we're accustomed to in the United States. So, this basically requires continued involvement by the private equity firms.

Rogers: I think it's worth adding, too, just on a geographic basis, Steve, you mentioned the China market being shut down, essentially, for the last year or so and just starting to get reopened. In the European markets, the U.K. market has been very strong. I was in London from 2009 to 2012, where you could almost call it a shutdown. There were about six deals done in one year, I believe there, something very small. Those markets are coming back now, too, which adds to the global health of the IPO market, as well.

Sammut: I agree with that very much so.

Knowledge@Wharton: Let's move onto talk about EMEA — Europe, Middle East and Africa — that region has had an especially strong IPO performance recently, as you were just alluding to. Overall deals jumped from just six IPOs, raising \$2.3 billion in 2012 to 35 IPOs raising nearly \$18 billion last year, 2013. The early part of 2014 also looks strong; a 25% rise in January and February over 2012, so what are the dynamics behind this rapid growth rate? Mike?

Rogers: Well, again … the window of time when I was in London, 2009 to 2012, you woke up every day to the paper wondering, during part of that period, if the Euro was going to collapse, and a lot of the discussion was: How do we unwind this? How do we let Greece out of the Euro Zone without a major catastrophe? All that talk has now completely gone away, of course, and that market sort of soothed itself over the last 24 months.

But, what they're left with now — as, you know, the Central Bank stepped up and sort of put the cushion underneath it — and so it is a slow growth economy for some period of time. You can circle in the number of the years that you think that this is going to be a challenge. A lot of the folks there are worried about deflation, as opposed to inflation. What that's done, though, is … some of these austerity programs have taken place … and Greece seems to have of stopped hitting worst-case scenarios. They at least are stabilizing a bit.

So, the discussion's moved from a crisis economy into more of a stabilized one, and it's begun to come up from the bottom. And as a result, you had almost essentially a dead IPO market in 2011, 2012, and now, even a small number — in historical numbers, even a small growth on a percentage basis, looks big. But, it is speaking to the fact that people are getting more confident there. I think there was just some recent data released about the confidence improving in the U.K., and some of the programs that they've instituted there are starting to pay off. So, we really see it as having stabilized and now, beginning to tick upward, which is good for the developed markets, to have a stable U.S. market and a stable U.K. and EMEA market.

Sammut: It is very encouraging to see what is going on in Europe, how that carries over to the fuller economy remains to be seen. But, what it does suggest is that there is a pent-up demand for these offerings and perhaps some underlying confidence in where things are going. The interesting story with IPOs is also in the Middle East and Africa, and I think that's worth coursing out a little bit.

The Middle East, in particular, has growing strength and integrity of its exchanges. So, the Dubai Exchange, for example, is becoming a venue for listing.…The MENA region is taking on, or the GCC region, is taking on a life of its own, as far as the capital markets are concerned, and that probably will continue for the foreseeable future.

In Africa, yes, there has been an increase in IPOs, but I don't think that's really the name of the exit game or the liquidity game yet. But, I think the driver behind PE in Africa is not going to be so much IPO exit as the possibility of trade sales and private sales of companies, and that probably will characterize how that market works for some time to come. And the reason is many of these companies that are being funded by P.E. firms become very attractive entry points for multinationals and other companies to bridge their way into the African market, so probably, there's going to be as much price competitiveness for acquisitions as there would be value in an IPO.

Rogers: We see many of our client funds moving into Africa to follow up on this trend. There are opportunities there to provide growth capital in many of these markets, so I agree with Steve that the IPO market is still fledging there, but I think that there will be other ways of exiting. We just released our most current Africa exit study that speaks to that in great volume, but it talks about how many of the sales go to other trade players or private equity funds as they graduate up the sophistication curve and size curve as they grow their businesses.

Knowledge@Wharton: Last year, 2013, shaped up as the best fundraising year since 2008. Proceeds rose 17% over the previous year to about $400 billion, and in the latest EY private equity capital confidence barometer, two-thirds of general partners contacted said they're optimistic about the fundraising environment, which is up from just 41% a year ago. That's a big move.

Rogers: We are seeing a greater interest in fundraising this year. It was — as you mentioned, up 17% over 2012, but the first quarter of 2014 was slightly flat, so we may have seen a little bit of the spurt and maybe a calm down a little bit. The interesting trend is that number that you quoted in our study represented a smaller number of funds actually raising more money, which I think is the critical issue. Everybody's heard about this concept — I think people anticipated that actually, there would be some consolidation in some of these funds, that sort of thing — small cap, mid-sized funds might ultimately merge with other funds just because of the constraints and challenges around fundraising, but we haven't really seen that.

What's really happened is the LPs are making selective decisions and putting more capital with the bigger funds. And so, we're seeing a transition in the industry, if you will, from some of the smaller or middle market funds … some of them are opting not to go forward. They are going to manage out of their expectations, out of the investments that they've made already, and they've decided and publicly announced, "We're not raising another fund."

What that's done is driven more money into the hands of the biggest players. So, you are seeing many more multi-billion dollar facilities hitting the peak record that we hit, in 2006, 2007, 2008, when we had some very large funds put together, but we are seeing more money flowing towards bigger funds. I think one of the phenomenons there — and I've heard this from a lot of the LPs directly, they are looking for one to make their life simpler, to have fewer places that they have to monitor and govern funds, so they collect that money with one group.

Oftentimes, it helps them in terms of, if they were using money and had money set aside for, say, distressed debt, and then they also were putting money into private equity and they're putting money into some form of an energy sector or an emerging markets funds. But what they'll do now is not unlike an individual might, they'll consolidate those funds with one player who has all of those capabilities in shop — also, trying to see if they can get any fee breaks along the way. So, it's just — it's a consistent trend — some bigger funds and I think that will probably continue. But, the market's been relatively healthy for fundraising, I'd say.

Sammut: Very much so — at least, since the last five or six years. We are seeing this haves-and-have-nots phenomenon, as you've just pointed out, and I think there are a lot of things going on there. While it is in the study that EY has done, there's another factor in this, and that is more and more of the LPs want to do direct investing. And this is not measured in billions of dollars, but if you start to factor in that trend, you see that maybe even more money is flowing into this asset class or things you can attribute to this asset class than there have been before.

And that may be another reason for wanting to consolidate the investment in different funds. Michael mentioned that they may be looking for fee breaks and I definitely agree with that. That is a very important theme in this asset class. But many limited partners are now seeking to extract other investment rights, as well — for example, a co-investment right, wherein on a selective basis, they can take a piece of the offering on a direct basis and have a more potent relationship with a smaller number of funds.

Among the other impacts of the amount of money going into a smaller number of funds, and in the EY data, that was quite pronounced, the money flowed into some 600 or so funds, which was 100 or more below previous years — I don't remember the numbers specifically. But, that — a smaller number of larger funds — has some pretty significant implications going forward as to what the investment strategies of these funds are going to have to be.

If the middle market gets crowded out or diminished, it's going to mean that for the relatively few large cap opportunities, there's going to be more and more competition, and that the valuations of these prospects are inevitably going to increase. That isn't necessarily a good thing over time. So this is a phenomenon we have to keep our eyes on quite closely.

Rogers: I'd add to your comment and emphasize your thought about the LPs in the process there. I'd almost call it an era of LP rights, because they are asking for the co-invest, they are asking for fee breaks, they're getting a little less comfortable with the traditional fee structure of the industry, and starting to question — as returns have come down — when returns were in the mid-30s, (30%) you kind of didn't mind paying your management fee, because you were extracting some nice value from these transactions. As returns moderated into the low 20s or even high teens for many of the funds, it becomes a little stickier in terms of having a desire to pay that high of a management fee.

The co-invest thing is certainly a big issue as well. We think a current trend is that a lot of these funds are starting to hire professionals in the PE industry and looking to just go direct. And we're seeing more and more emphasis and request for services from those types of entities that are looking to go make their own direct investments. That is a trend we have to look for.

The last thing I'd add around this is on the allocation side — we do see many of the pension funds allocating more towards private equity or alternatives, and more and more money is finding its way into private equity coffers, if you will, to go spend, because everybody knows that these funds have obligations to meet. Many of these obligations have been set in time for years, and given the low-yielding bonds right now, they've got to seek some return. Most prudent investment management companies or pension companies have looked at that and said, "We have to find some yield here." They're looking for some alternatives. So, there is a little bit of a breeze at the back of fundraising right now for most of the funds.

Sammut: That's an extremely important point. Maybe the flip side of that, and that is with the financial crisis, especially in the wake of such a dramatic uptick in private equity in 2006, 2007 and 2008, what happened, literally overnight, was that the portfolio allocations of the financial institutions got way out of balance.

Typically, the boards of these funds will set a target of 5%, 10%, 15% of assets to be allocated to private equity, and that's fixed. That takes a long time to distribute. When there's a huge down draft in the value of equities, suddenly, firms found themselves managing nominally, half the assets they had. And basically, their allocation to private equity or all of their alternates was double what it's supposed to be. Now, that's coming back into balance with the improvement of the public markets, and that is, I think, one of the tailwind factors that Michael referred to.