Private Equity: On the Rise in 2015

Knowledge@Wharton offers this two-part podcast interview on private equity highlights for 2014, and a look ahead to 2015, with Stephen M. Sammut, a senior fellow and lecturer at Wharton, and Michael Rogers, EY's global deputy private equity leader. U.S. IPO proceeds, and the number of M&As, rose strongly in 2014 and "that generally portends well for private equity," said Sammut. But "it doesn't necessarily mean that their rates of return are what the expectations were when the limited partners made their investments seven or eight years ago." Nevertheless, adds Rogers, "record levels of exit activity are leading a lot of limited partners to re-invest those funds back into the asset class at elevated rates...."

An edited transcript of their conversation follows:

Knowledge@Wharton: I want to thank Michael Rogers and Steve Sammut for joining us once again at Knowledge@Wharton to discuss some key issues in private equity (PE) today. Michael is EY's global deputy private equity leader, and Steve's a senior fellow and lecturer here at Wharton, who closely follows private equity and is also in the business.

We'll start with part one of our discussion today. Let's talk about what's happening in the U.S. in PE most recently and looking at 2015, too. To put it into context, in the U.S. IPO proceeds for the first three quarters of 2014 were way up over 2013, much of it coming in the third quarter after the big Alibaba IPO seemed to release the flood gates. In the third quarter, the number of listings spiked almost 30% over the same 2013 period. And the amount raised — $67 billion — was up 162% — quite a surge. Expectations were that the fourth quarter would be strong, too. If you look at the first three quarters for 2014, they're also up. For the first three quarters, there were 220 IPOs in all U.S. exchanges that raised $77 billion, which was up 16% over the same period in 2013. What does all that say about private equity in 2014?

Michael Rogers: Clearly PE has played a big part in the performance of U.S. IPO markets. So far I think they've accounted for about one third of the number of deals and most of the value that's been raised. I think that really speaks the resilience of the industry. A lot of these deals were entered into before the crisis several years ago and it was questionable as to whether they would ever again see the light of day or be above market. PE stuck with it, stuck with a lot of these companies, ushered them through the downturn, and turned them into companies that are attractive for public market investors. What that's done is brought private equity outside of the danger zone in which it's spent the last several years. We think about that as the concern that PE firms would be unable to achieve sufficient liquidity on their portfolio companies that they had built up over the last decade.

Knowledge@Wharton: Mike ... that was back in the darker days right after the crisis — that was referred to as the "wall of debt" as I recall. Is that right?

Rogers: That's correct. We were very concerned that those companies were going to be stuck there forever. We did see an extension out of the hold periods for private equity. Many of our studies and reports that we've done have noticed that push out in hold periods. But ultimately, those who stuck with it, worked with the companies and management to do a great job to build those businesses, have now reaped the rewards and taken advantage of this hot IPO market.

Knowledge@Wharton: What is the significance of this performance by IPOs for the coming year?

Stephen M. Sammut: This is a very critical question and it's the source of some skepticism I hold with respect to the ultimate liquidity of the private equity sector. And the reason is this: Private equity funds, unlike in days gone by, had to take pieces or positions within the public offerings themselves, and by and large are still holding their ownership positions in these companies. It's only through secondary and aftermarket sales that they will actually be able to achieve some liquidity. Now, that will be just fine if the market continues to stay where it is or improves — there will be demand for those positions. But until that time, the checks that they're writing to their limited partners are still somewhat limited.

Overall, having a vibrant IPO market, which is buoying up the overall indices, is good for private equity, it's good for venture capital, because it means that the money managers are going to be looking to continue their allocations into the sector. That is to say, the current limited partners and perhaps new limited partners will have very large treasuries to allocate towards the alternative assets.

Knowledge@Wharton: What industries look like they're going to get the most interest?

Sammut: The industry I watch most closely is health care. And in both the U.S. and overseas we've been seeing over the last few years an unprecedented interest in health care. In the United States, to some extent, that has been a response to the changes brought by the Affordable Care Act, otherwise known as Obamacare. And that has stimulated some consolidation in the industry — but especially reorganization and moreover the need for capital infusions by many of the health care companies. The private equity funds were willing to step in, either on a growth equity basis — they took minority positions but provided cash or in some cases control positions or buyouts in order to move the companies further.

Now we're in a period where we're beginning to see some harvesting, which will probably go well and inspire further investment in health care in the U.S. That also stimulates some interest in the producer side of health care — the companies that are making products. So, for the first time we're actually seeing in later stage bio-tech — or in pharmaceutical companies — private equity plays as well. And those are exiting — if not by public offerings because these are frequently publicly traded companies already — we are seeing things play out in the M&A market.

Knowledge@Wharton: So, a first time for that trend that you're citing.

Sammut: In the numbers that we're speaking of, yes.

Knowledge@Wharton: Mike, which sectors are likely to generate the most interest?

Rogers: Well 2011 and 2013 were very busy years for PE IPOs in the U.S., but what's made this year particularly interesting is the breadth of companies we've been seeing come to market. In fact, while health care has received mention, consumer goods and tech have kind of led the way. We've really seen companies across a wide range of industries come to market. And the appetite for new deals and the risk tolerance of investors right now is very accommodating of companies in different sectors and different business models. And we think that's probably something that will continue for awhile here, assuming the markets stay as buoyant as they have been.

When we look at the pipeline we see more of the same. Probably tech, health care, retail consumer goods and financials are all well represented. We normally have included or thought about oil and gas in that arena. But the recent down draft in prices — from $110 to the high $70s — say over the last month or month and a half — has dampened a little bit of enthusiasm regarding oil and gas. It's still a long-term interest, still a long-term play, but the dynamics and the financials look a little different for some of those companies,

especially emerging energy companies when you have those sorts of underlying trends and commodity.

Knowledge@Wharton: When you try to evaluate what's happening in private equity, if you look at say, at the IPO markets and maybe M&A also — if you just look at those two, are you getting a pretty good idea of the trend in PE also? Do they travel mostly parallel paths? To what extent can you gage the health of PE, which isn't always something you can follow publicly, by looking at what's happening with IPOs and M&A, which are mostly public?

Sammut: One of the proxies for that is to look at what the fund-raising trends are in the industry. And in the years following the financial crisis, there was a steady, somewhat uneven at times, improvement in the flow of capital into private equity funds. This was at a time when there was very little liquidity. But during that period as stock prices recovered, therefore asset values overall recovered and triggered new allocations, or the restoration of allocations to private equity.

This is a very difficult area to study with any kind of scientific precision or academic integrity. But what we do see is that there's almost a counter cyclicality to this. I suspect in 2014 [year-end results] and then actually well into next year we are going to see a fairly significant inflow of capital to private equity. And that is likely to come from a wider range of limited partners than we currently see.

So, to answer your question, when M&A is active, which it is almost at historic levels at the moment, and IPOs are in the news, that generally portends well for private equity. But as I said earlier, it doesn't necessarily mean that their rates of return are what the expectations were when the limited partners made their investments seven or eight years ago.

Rogers: I agree. And going back, Steve, to one of your earlier thoughts regarding the pent up value of stock — stock value, if you will, that's tied up with PE funds because of the lock-ups and things of that nature — I think that's a very real issue. It's very much of a concern in some places, in some funds, because it's fine as long as the markets continue to rise. But if they're holding on to big chunks and if the markets dip down a little bit, that's going impact them directly.

Regarding how the industry looks at where they are, in terms of how IPO markets move relative to the M&A markets and private equity investment, I think it's a couple things. It's probably confidence and stability that underpin both. Right now confidence appears to be pretty high. The biggest area where we're seeing this have an effect is in the fund-raising markets. The record levels of exit activity are leading a lot of limited partners to re-invest those funds back into the asset class at elevated rates quite frankly. Right now, I think firms are on pace to raise almost $500 billion globally this year, which would be the best year since the crisis as Steve touched on. That in turn helps drive activity, as there's more capital available.

But to be fair, I think that connection isn't as strong as it once was, which I think leads to Steve's comments – that it's a hard area to study because PE firms have had a lot of dry powder the last several years and haven't been as active in the market. So, they're reducing the cycle — the reliance on the fundraising cycle a little bit I believe. But we have seen that strength when a lot of new investment comes back into the market, when you get higher allocations from pension funds and different areas — LPs, endowments, etcetera — that does bode well for future investment for PE.

Sammut: The M&A implications actually go well beyond the excitement building in private equity. We have to recall that when we're talking about M&A, we're typically talking about transactions of one company acquiring another. That basically means there is more and more competition for private equity funds against strategic acquirers who sometimes are willing to pay more of a premium for the buy-outs than the private equity funds would play.

This hasn't played out fully yet. To some extent it's good because … you're leveraging positions, there's confidence … fueling this as Mike noted. But it is definitely going to affect the pricing of opportunities. And if prices for the acquisitions go up, that has longer term negative implications for the returns that the funds will eventually deliver.

Knowledge@Wharton: EY's 11th Global Capital Confidence Barometer looking at M&A found that 81% of US executives expect the M&A market to improve. So, people are bullish on what's coming up over the next quarter or two at least if not more.

Rogers: This is something that we've tracked for over five and a half years now through this semi-annual survey of more than 1,600 executives across the globe. I was in London for three and a half years and I ran this program on a global basis for the firm. So, I'm intimately familiar with it.

The 81% of the U.S. executives that expect the M&A market to improve — let me put that in context — when we were doing this analysis in the depths of the downturn in 2009, 2010 we could at times get reports of say 20% or 25% of the group feeling that the markets were going to improve. That shows you just how far we've come. Maybe it's gone too far the other way but there's a tremendous amount of confidence. As we found in the last survey, there's a big uptick in expectations in the U.S. market. I think the U.S. market is disengaged a little bit from the rest of the world market — decoupled — because it's actually improving and the perception of improvement is much higher than around the world.

A couple of these big billion dollar deals have ripple effects into the middle market and that's where a lot of PE activity is focused. I think this will probably result in more competition for PE investors trying to do deals…. We've already seen that competition. A number of our clients are telling us that they feel valuations are too high already. But it does portend well that M&A is an exit route, there's still a lot of activity and that's where PE is focused right now.

Knowledge@Wharton: Thank you both.