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Private Equity is Done…Well, Not Quite (Part Two)

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Last week we began to respond to the WSJ op-ed by Andy Kessler in which he stated the glory days of private equity are over. We first reviewed how many ups and downs the industry has had over the past thirty or so years; at least seven stages, at the end of each of which observers could reasonably have declared private investing to be “done.”

Successful equity investors look for undiscovered value. Those opportunities abound when markets go through major corrections and are scarcer when purchase multiples soar. Today sponsors are clearly dealing with headwinds, as Mr. Kessler suggested. But to trumpet the end of days for PE misses the adaptive nature of these investors.

Yes, right now there’s too much cash chasing too few deals. But that benefits PE sellers and their LPs. Firms that show better returns will be rewarded with more LP dollars to recycle. The rest will be challenged, as always happens in periods before a shake-out.

Let’s take the first of the op-ed’s points – that rising interest rates will hurt PE. Certainly the market has been expecting higher rates for a while. And higher interest expenses do cost portfolio companies more money. But where was Libor at the peak of the glory days? In June 2007, 30-day Libor was 5.25%. Today it stands at 0.18%. If the Fed raises rates 25 bps every quarter beginning in June, it would take five years to get back to where we stood back in 2007. We think that’s plenty of time for PE to adjust their capital needs.

How about the fact that banks are getting out of the lending business? Certainly the pressure on banks to avoid “risky loans” is creating an interesting supply/demand dynamic in the leveraged world. But as we’ve often pointed out in this space, there’s been a significant influx of capital for lending from non-bank institutions. Everyone from pension funds, to insurance companies, even to arms of PE firms, is jumping in to fill the void left by banks.

Then there’s the issue of tax reform. The Lee-Rubio plan to eliminate deductions for interest could hurt users of debt. But even if such a proposal makes it through a dysfunctional Congress in a pre-election year, the overall benefits to the economy of lower corporate taxes and a simplified individual code would far outweigh any drag on deductions.

What about the argument that PE loads companies with debt, strips the assets, and cuts expenses to the bone? Our experience, particularly with middle market companies, has been quite different. Sponsors seek to invest in companies that need capital and professional management to grow. They figure out ways to take good companies and take them to the next level, to make them great companies. That enhances value for shareholders, including management teams, and then monetized in an exit.

Certainly there are cases of leveraged borrowers that get flipped with no productivity improvements. But those get reflected in diminished values, and offending sponsors don't get rewarded by their LP investors.

Next week we conclude our thoughts on private equity with a look at what stage the industry is currently in, and where it'll be in the years ahead.