INDUSTRY INSIGHT

PRIVATE EQUITY *by* **Mark Bremer**

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Making advantage

Even though market conditions have turned from buoyant to unforgiving, buyout funds that can separate themselves from the field will continue to thrive

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Many LBO principals have been commenting recently on the challenges of the current environment. They highlight a need to differentiate themselves both to investors and to target companies, given the number of funds and amount of capital competing for deals. While overall circumstances certainly present more challenges today than in recent years, these same circumstances might also create opportunities for those who can truly differentiate.

The concerns are not surprising, given trends in recent years: much more money chasing the same number of, or fewer, deals; challenging lending terms; and difficulty in getting the sort of leverage that was commonplace in the past.

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Average contributed equity in deals increased from 22% in 1992 to over 38% in third-quarter 2001, according to **Portfolio Management Data LLC.** The same source shows bank loan interest-rate spreads increasing 25% on loans under $100 million from 1996 to 2001, and 34% on loans from $100 million to $250 million.

Also significant is the narrowing gap in valuation between public and private markets. Assuming a four-year holding period, we compared Ebit and Ebitda multiples for the S&P 500 to middle-market M&A multiples four years earlier. For example, we looked at the middle-market M&A Ebit multiple for 1994 (12.0) compared with the S&P 500 Ebit multiple for 1998 (13.2), as a proxy for the market at exit for investments made four years earlier.

Some premium for size and liquidity is to be expected, but from 1995 to 1998 the differential was dramatic. During this period, the Ebit multiple premium for the S&P 500 compared with middle-market M&A multiples four years earlier was over 10% each year. It was 27% and 23% for 1996 and 1997, respectively (again assuming a four-year hold). The difference in Ebitda multiples for 1996 and 1997 was 18% and 13%, respectively.

The differential in valuation represented a significant arbitrage opportunity to buy in the private market and sell in the public market. Combined with the attractive leverage possibilities during the period, superior investment decisions could—and did—result in phenomenal returns.

The valuation difference was significant enough to help cover some bad investment decisions, too, making impressive returns possible even with more pedestrian investment selection and risk management.

These conditions were quickly recognized by the capital markets and attracted an unprecedented flow of capital and professionals to private equity. According to Buyouts News, private equity groups raised more than $130 billion from 1997 to 1999 (the three years following the largest differential in the multiples analyzed above), compared with about $50 billion from 1994 to 1996.

Valuations then came back in line as significant new capital flowed into private equity. While S&P 500 valuations started to decline after 1998, the comparison multiples for middle-market transactions four years earlier remained high. By 2000, the S&P 500 Ebitda multiple was actually 14% below the multiple on middle-market transactions four years earlier.

This situation provided far less cover for bad investment decisions, and the hangover of current holdings purchased during a time of high pricing will likely keep returns lower for many funds in the near term. As a result, competitive pressure on funds will likely remain high, both for fund raising and for deals. This pressure may even weed out some weaker funds and general partners.

Is this cause for concern? Certainly the weakest funds should be worried, but this is just the normal functioning of the market. As long as private-equity returns compare favorably to returns on alternative investments, private equity will remain attractive to investors.

Also, for those funds that can truly differentiate themselves, the current situation is in some ways beneficial and may lead to an improving environment. However, real differentiation will be required. To thrive, private equity funds will have to create real advantage in one or more of the basics:

- Better sourcing or active creation of deals.
- Better investment decision-making.
- Bringing real value to the management of portfolio companies.

Success in all these areas depends on developing superior expertise and knowledge.

One way to achieve this may take the form of specialization by industry, function or business model. It may involve combining internal capabilities with intelligent use of outside resources to generate proprietary market knowledge and insight. Or it may take the form of management guidance for portfolio companies, making strategic improvements or gaining incremental efficiencies.

Whatever route funds take, competitive advantage will be based on superior information and knowledge. The market—as it almost always does over time—will identify and reward that advantage.

The conditions that rewarded almost everyone who could get deals done may be gone for now, but the conditions that reward true advantage are always present. **D**

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