Zachary Scott
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Private Equity—Can You Raise It?

Liquidity in the private equity markets is making its way into new deals, but very selectively.

by Mark D. Working

Recently you may have heard that now is a good time to sell a business or to raise equity capital. The story goes that a tremendous amount of private equity capital has been raised over the last few years that must be put to work. The thinking behind this advice, offered by various investment bankers, brokers, and intermediaries, is that investors have been burned by investments in dot-coms and technology start-ups, so they now are looking to invest all that money in safer "old economy" businesses. The implication is that a lot of capital is poised to pour into mature middle-market businesses.

We are not convinced. Even though there is substantial liquidity in the private equity markets, it is not gushing into new deals. It is trickling in very selectively.

$100 BILLION OVERHANG

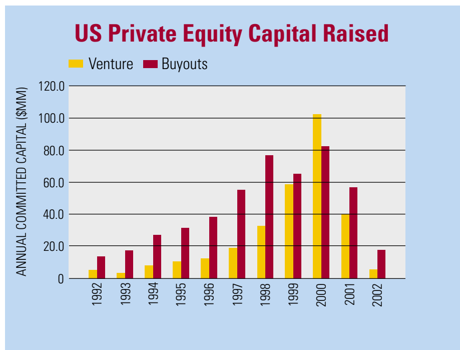
It is true that by historical standards, the amount of capital raised in the past five years is phenomenal—more than $300 billion, specifically earmarked for investment into later-stage private companies. Another $320 billion has been queued up for early-stage "venture" investments.

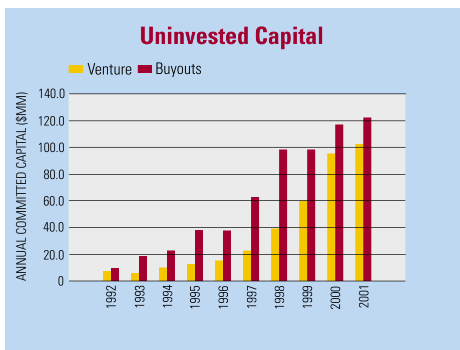
It is also true that the slowdown in the rate of investing has left a huge overhang of uninvested capital, estimated to be more than $100 billion. Since equity capital employed in private company buyouts is typically leveraged with debt, this implies that the total sum available to fund private equity investments is several multiples higher.

From frequent discussions with private equity firms, it is apparent that the pace of new investment is sluggish. Many investors report that their deal pipelines are as empty as they can remember. One would surmise that there is pressure building to put unused capital to work. If so, why isn't the private equity spigot wide open? Behind the scenes there seems to be another dynamic at work.

THE PRIVATE EQUITY BUSINESS

The private equity business depends on investment performance. Over the past 15 years, institutional money managers determined that overall portfolio returns could be enhanced by allocating a greater share of





capital to the "alternative investment" category—primarily private equity. This has been accomplished with investments in limited partnerships ("funds") that are stewarded by private equity fund managers. Early leveraged-buyout successes of the likes of Thomas Lee, KKR, Forstmann Little, and others accelerated the interest in these investment funds and led to the creation of the private equity industry.

> **Some investors have even demanded that funds return monies previously committed, but not yet invested.**

Private equity fund managers are compensated with fees tied to the amount of money under management and a share of the profits generated by investment of the fund's capital. Although management fees are not dependent on a particular level of investment returns, profit sharing is. More important, the potential for attracting investors to the next fund is closely correlated with investment success.

In today's environment, private equity fund managers are swimming against the current in the effort to earn acceptable investment returns and raise new capital. Recent investments by private equity investors have met with limited success. A combination of factors, including a sluggish economy, the negative impact of leverage in tougher times, overly enthusiastic investment expectations and assumptions, and a tight public equity market, have diminished the overall value of many private equity portfolios.

This has happened on such a grand scale that institutional investors are rethinking their allocation decisions and have pulled back from the private equity asset-class. Limited partners had lofty expectations when they committed to private equity funds, and disappointment is setting in. Some investors have even demanded that funds return monies previously committed, but not yet invested. In this environment, the energies of fund managers are being directed toward their problem investments (e.g., changing management, rethinking strategy, and refinancing the businesses) and attending to disgruntled limited partners.

The personal fortunes of fund managers depend on raising more capital. More capital can be raised only if the track record has been good. It hasn't been. For this reason, fund managers are hesitant to invest in anything but the very-highest-potential opportunities. Unlike in past years, private equity investors are warily avoiding the types of risk that burned them in the past. Volatile market demand (less than a dominant market position), execution risk (no more rollups), optimistic projections (having to rely on lots of add-backs), and inexperienced management teams are major red flags.

RISK IN PERSPECTIVE

Risk again has been put into perspective.

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In our own dealings, it is clear that investors remain cautious. They are undertaking extensive due diligence and accepting no fact without independent verification. Lenders are following the same drill.

Even if a prospective investment stands up to heightened scrutiny, debt is less readily available. The cost of debt is lower, but the constraint on its availability means that equity must fund a larger share of the capital structure. Because equity investors' return expectations have not declined, a shift in the mix of debt and equity in a deal increases the weighted-average-cost-of-capital. Higher capital costs connote a lower value for the cash flows from business operations.

Pressure on operating cash flow, murky economic prospects, higher weighted-average-capital-costs, lower business values, and the extreme scrutiny of business risk by investors combine to make this a difficult time to be in the market selling a business or raising private equity capital.

It is true that when large, profitable firms with leadership positions in growing industries do come to market, their values are bid up. Demand for low-risk, high-performing businesses far exceeds the supply. Unfortunately, this phenomenon applies to only a small segment of companies. Of course, these situations make good news stories that lend credence to the advice that private equity is freely available. Forgive the bankers; they are only trying to make a living. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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