



Market Heats Up for Private Company Sales

Owners of private businesses are influenced by current market conditions.

by Mark Working

The markets for financial assets are cyclical, and the value of privately held companies is no exception. For several years, we have commented in IN\$IGHT on the continuing reduction in the cost of private capital and how that has ratcheted up the prices paid for private businesses. We are not alone in this assessment as the data show that owners of private businesses, especially institutional owners, are taking advantage of current market conditions to realize the value of their investments.

TRANSACTION CYCLES

The last cycle of private company sale transactions peaked in the first quarter of 2007, prior to the recession. That quarter marked the high point for the number of transactions completed by both entrepreneurial (individual) owners and institutional (private equity and corporate) owners. Following that peak, aggregate sale activity fell off until the second quarter of 2009, corresponding to the official end of the recession. Entrepreneurial owner transactions fell off 50% from the peak while institutional owners dropped off 34%. Since then, volumes have trended upwards, peaking in the fourth quarter of 2012, in anticipation of the increase in tax rates on both capital gains and ordinary income.

The adjacent chart presents a comparison of three financial metrics; the number of sale transactions by entrepreneurs, the number of sale transactions by institutions, and the S&P 500 index, all indexed to their levels at the peak of the last cycle (1Q 2007). Interestingly, private business sale activity has roughly correlated with the rise and fall of the public stock market, corresponding to our observations over the past twenty-five years that owners of businesses are more interested in selling when they believe they are “at the top”.

Prior to the peak in 2007, private owner transactions hit a low following the dot-com bust. All owners embraced the improving market, but entrepreneurial owners especially enjoyed the party up until and after the financial meltdown. At the peak, entrepreneurial sellers represented the greatest share of total transactions in the last twenty years, never reaching that level since. In the current cycle, institutional owners accessed the market quickly after

the downturn and have been on a selling spree for the past four years, peaking at a transaction level a third greater than the prior peak. Comparatively, entrepreneurs have also participated but to a lesser degree. With the fourth quarters

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of 2010 and 2012 representing the major periods of activity for entrepreneurs, it is clear that the specter of increasing taxes, possibly more than market dynamics, affected their decisions.

CURRENT MARKET DYNAMICS

Institutional owners are continuing to take advantage of the high values and ample liquidity that characterize the current market. Astute private equity investors are taking this opportunity to head for the exits.

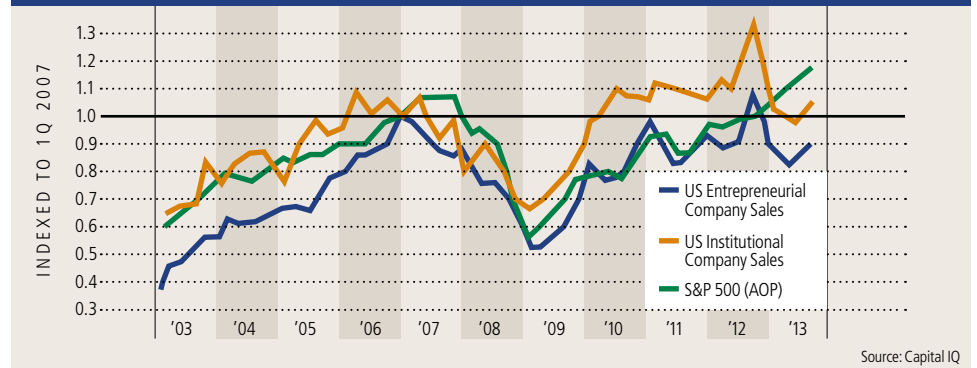
“There’s a time to reap and a time to sow. We’re selling everything that’s not nailed down.”

Leon Black
Apollo Global Management

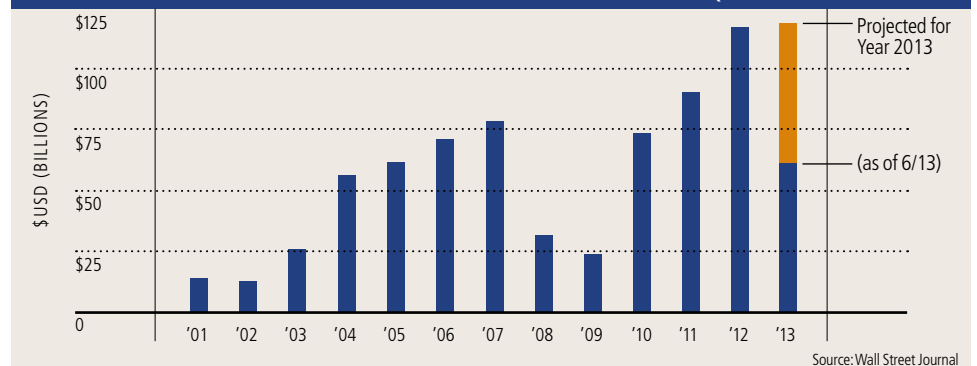
“If private equity firms haven’t been returning boatloads of money recently, given current market conditions, I view that as a red flag.”

Andrea Auerbach
Cambridge Associates

SALES ACTIVITY BY OWNER TYPE (INDEXED VOLUME)



CASH RETURNED TO INVESTORS BY PRIVATE EQUITY



With these exits, private equity firms have returned a record amount of cash to their investors. The graph on the previous page shows that private equity firms will have returned nearly \$125 billion to investors in each of the last two years. Indications are that this trend will continue in 2014.

The current cycle has been boosted, at least in part, by the Federal Reserve's ongoing efforts to hold interest rates low. This has, in turn, driven investors to the equity markets in pursuit of greater returns. Blackstone CEO, Stephen Schwarzman, was quoted at a recent conference thanking Ben Bernanke for investors' prosperity.

We know that business/investment cycles invariably end, but the end only becomes apparent in retrospect. As discussed in the following article, A New Year Begins, the Fed is having a profound effect on all markets to the benefit of capital acquirers. Although the would-be experts profess confidence that the rate regime will continue into 2016, we'll only know for sure with the passage of time.

Capital is abundant and at historically low cost. Those private business owners who do not expect to own their businesses through the next cycle should not wait for improvements in performance. We think owners should

educate themselves about the market and the specific options available to them to monetize the wealth they have created. The tradeoffs of company performance, time, risk, and capital requirements should be evaluated in terms of how the market values businesses. We continue to believe that it is extremely important for owners to understand what drives intrinsic or economic value, as well as how the private markets affect the value of their businesses. Market conditions are very good right now but, as we have learned over the years, conditions often change abruptly. **zs**



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