

Cycle? What Cycle?

Observers remain bullish on private equity going into the New Year, though questions linger

2007

A look back provides a **2007** roadmap for the private equity and private placement markets

Predictability is out the door. If there's anything the private equity market can take away from 2006, it's to expect the unexpected. And as industry sources reflect on 2006, they make clear the danger in predicting for the year ahead.

This is due in part to the fact that while there were signs at the end of 2005 that PE would be on solid footing, nobody was anticipating what has taken place during the past 12 months. In fact, **Silver Lake Capital's Glenn Hutchins**, a co-founder of the firm, warned this past January that there could be "a real shakeout in the business" (*IDD*, "Private Equity Party Rolls On," 1/9/06).

When it comes to investing, Hutchins is rarely, if ever, off the mark. But his market prognostication, in hindsight, leaves something to be desired.

2006 will be remembered as the year private equity came out of

its shell. Year to date, there has been \$371 billion worth of disclosed domestic deals, representing a 128% jump over last year, according to data provider **Dealogic**. The still-growing number looks even more impressive when lined up against the years preceding 2005, as it exceeds the total four-year sum of \$116 billion from 2001 to 2004.

“The growth of the market has been astounding,” says **American Capital Partners** principal **Mark Opel**, who gives Hutchins a free pass, saying, “It’s more than anyone could have predicted.”

Indeed, certain benchmarks that were once untouchable have been shattered. **RJR Nabisco** — **Kohlberg Kravis Roberts’** storied \$25.1 billion deal in 1989 — has been eclipsed by three separate deals this year after having spent the previous 17 years as the largest LBO ever. Meanwhile, when 2006 started, **Goldman Sachs’** \$8.5 billion fifth fund stood as the industry’s largest. Twelve months later, that number already seems remarkably small. **Texas Pacific Group**, **KKR** and **Blackstone Group** have each raised as much as \$15 billion, and Blackstone, in October, reportedly reopened its fund to chase down as much as \$20 billion of capital.

Even as nobody predicted this kind of vigor for 2006, some of the guesswork for what still lies ahead might appear overly exuberant. **Apax Partners** CEO **Martin Halusa** was quoted by *The Times* of London predicting there would be a \$100 billion private equity fund by the end of the decade, and **Carlyle Group** co-founder **David Rubenstein** earlier this month told the *Financial Times* that he wouldn’t be surprised to see a deal of that size within the next two years.

Forecasts like these imply that cyclicalities have been squeezed out of the market. In the past, private equity seemed to work in five-year increments, with deal volume and fundraising graphs depicting a series of bumps, each separated by an accompanying trough. Should the visions of Halusa and Rubenstein materialize, it means there’ll be no trough to the right of what has already been a dramatic ascent for the industry.

While optimism does indeed abound, some investors are keen to exercise caution even as all appears well.

“When the economy does slow down — and I don’t think it’s a 2007 event — that’s when you’ll start to see some more cracks in the system,” says **Genstar Capital** chairman **J.P. Conte**. “Liquidity comes in and out. We saw it disappear in ‘01 and ‘02. I’m not expecting to see that happen next year, but we’re going to see it again. We always do.”



Genstar Capital’s J.P. Conte:

‘Liquidity comes in and out. We saw it disappear in ‘01 and ‘02. I’m not expecting to see that happen next year.’

Carousel Capital partner **Bill Hobbs** agrees. “The financing market has been remarkably strong, but it’s a potential minefield,” he says. “There’s always something that precipitates a credit crunch. It’s not something I’m expecting in the near term, but usually whatever it is, it’s unexpected.”

Meanwhile, private equity as an industry has never been judged solely on its ability to take over a company. The real test comes in the exits, and with deal sizes hitting new heights, nobody’s certain where exactly the realizations will come from. This is not a major concern for small and mid-market firms, as they can always sell up the food-chain to larger shops. But in the large end of the market, the area where new ground is being broken, there is some uncertainty about where the next pool of buyers will come from.

“Nobody is asking the question of how people are going to exit these [mega] deals,” Conte says. “They’ve got answers regarding the opportunity and the risk, but I’m not sure there’s any answer yet about getting out.”

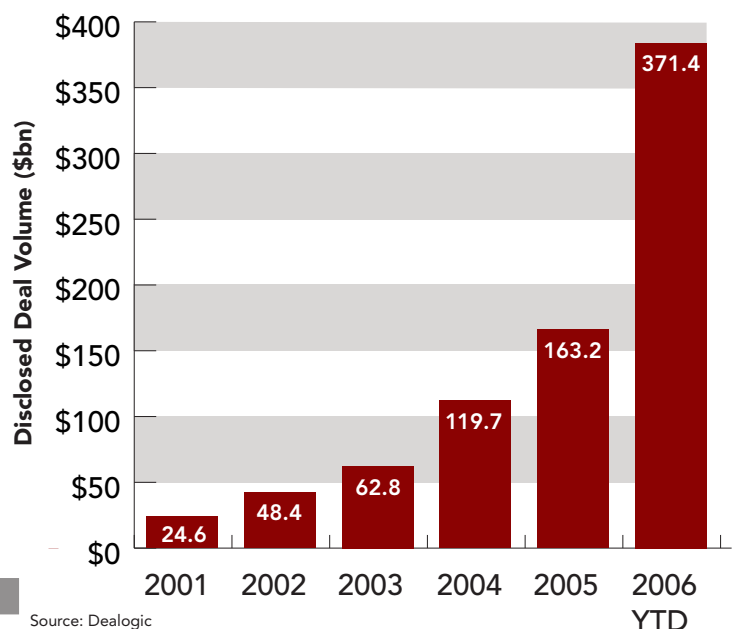
More of the Same

To be sure, 2006 has probably sparked more questions than answers. On top of reservations about sustainability, new uncertainties have arisen. The Department of Justice launched an inquiry into club deals that has the potential to impact how firms cooperate with each other. There’s no sign that the probe will evolve into anything more than an informal investigation, but should it develop into more, deal sizes would certainly be affected. Firms would likely shy away or even be forcefully prevented from participating in the club deals that enable the massive, HCA-style LBOs.

Also, leverage has ramped up to levels that haven’t been seen since the 1980s. It would take only one high-profile meltdown to create a backlash, and considering just how much debt is buttressing some deals, such an occurrence may be a matter of when as opposed to if.

Another quandary buyers are facing is how to be a smart shopper when purchase price multiples are either approaching or have surpassed record levels. Indeed, liquidity drives private equity, but

Domestic PE Deal Values



Source: Dealogic

a too-liquid environment can at the same time set a dangerous trap.

“The market’s operating at a very rapid investment pace,” says **Apollo Management** managing director **Josh Harris**. “We’re just focusing on keeping that pace rolling, but at the same time you’ve got to be very cautious in this environment. Things aren’t exactly cheap right now.”

Despite these questions, though, investors are still decidedly bullish about the near term.

“There’s a different dynamic today that wasn’t there before,” American Capital’s Opel says. “Private equity has become a much more important part of the economy. There has been so much money raised, and there’s so much liquidity, private equity is doing things it couldn’t do years ago.”

Opel adds that while cycles will come and go, he believes the industry’s expanded role in the economy is a permanent shift that

won’t dissipate with the industry’s next trough.

The question now is when will that next trough come? Few see any signs that it will occur in 2007, though there are reservations about the housing market and how the Fed’s fear of inflation may impact interest rates. That said, there are still no indications that suggest an end is in sight. **William Roman**, a managing director at investment bank **Harris Williams**, confirms: “Our backlog is stronger today than it has ever been by just about every measure.”

So what about those predictions for a \$100 billion deal?

Apollo’s Harris can be counted among those who remain skeptical. “It’s not the private equity market that’s constrained,” he says. “It’s the global finance market. For a deal like that to happen, you’d either have to tap into new markets or leave a bundle of debt outstanding.”

A safe hedge for a market that has already defied expectations.