Why private equity is here to stay

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Despite turmoil in global credit markets, private equity is alive and well, with ample funds for investment.

"The private-equity gravy train has jumped the tracks," declared *The New York Times* last fall, while *The Times* pronounced, "The buyout bubble has burst." The global credit crunch of summer 2007 and the cancellation of some high-profile private-equity deals have raised doubts about the sector's ability to sustain its high levels of growth.

Yet, a new joint study by The Boston Consulting Group (BCG) and IESE Business School reports that this pessimism is unwarranted. The study, "The Advantage of Persistence: How the Best Private-Equity Firms 'Beat the Fade,'" states, "Despite recent troubles, the basic elements of the private-equity business model remain very much in place."

The study's authors - Heino Meerkatt, John Rose and Michael Brigl of BCG and Heinrich Liechtenstein, M. Julia Prats and Alejandro Herrera of IESE - maintain that private equity will continue to be an important source of capital. The study predicts that the credit crunch should not stifle the sector's long-term growth, which is estimated to grow by 15 percent to 20 percent each year until 2011.

Ample funds for investment

There are still substantial amounts of money available for investment. Through 2006, the private-equity sector in the United States and Europe had accumulated nearly $300 billion in uninvested capital. This committed capital will be a powerful impetus for future deals.

Also, new capital continues to flow into private equity. In a recent Citigroup survey, 50 pension managers from the United States and Europe reported that they intend to raise their allocation in "alternative" investments, such as private equity and hedge funds, from 14 percent to nearly 20 percent by 2010.

New categories of investors are also showing up on the horizon. For example, government-owned sovereign wealth funds (SWFs) have recently discovered private equity. In addition to investing in private-equity funds, they are taking ownership stakes in private-equity firms. In May 2007, the new $200 billion SWF of the government of China announced that it was acquiring a 10 percent stake in The Blackstone Group for $3 billion.

So, new money continues to flow into the sector, both from traditional pension funds and from SWFs looking for higher returns.

How the best firms "beat the fade"

On a risk-adjusted basis, private equity does not outperform the public capital markets. Nevertheless, it remains an extremely attractive asset class for investors. The reason: there are indications that the best private-equity firms consistently "beat the fade."

This means they avoid reverting to average returns, which, over time, afflict the vast majority of investment opportunities. So, some private-equity firms do have a strong likelihood of outperforming the market over time - something rarely witnessed in other asset classes, such as mutual funds or individual public companies.

Heino Meerkatt, the global leader of BCG's private-equity practice, describes it this way: "Over time, the value-creation performance of the vast majority of public companies fades towards the market average. Not so with private equity. We found that the performance of the top-quartile funds barely faded over the time period we studied. This suggests that the best private-equity firms consistently outperform both public companies and their private-equity competitors - and, thus, represent an advantaged investment vehicle."

To confirm this, the study analyzed the sources of value at 32 portfolio companies at seven European private-equity firms. The performance reflects a broad historical trend. When one looks at the sources of value from private equity over time, it's clear that there has been a long-term historical shift away from leverage and toward operational improvement as a key source of value.

Sure, private-equity deals are highly leveraged and it is
true that the credit crunch has made debt more expensive. Yet, the recent sudden rise in the

cost of debt should not be exaggerated. After all, it is still only at levels reached in 2005 (when private equity was already booming), and many financial institutions are still willing and able to provide debt.

So, while the increased cost of debt is likely to increase default rates for highly leveraged loans, the overall impact on private equity is likely to be modest. In other words, debt will be more expensive, but it's still available.

Thus, as the shift towards delivering improvements in fundamental value continues, private equity will become an even more robust alternative to the public capital markets.

What sets the best apart

When it comes to private equity's success, traditional structural factors such as size, scale or diversification don't seem to matter. "The best private-equity firms can generate above-average returns whether they are big or small, diversified or focused, global or regional," writes Heinrich Liechtenstein, assistant professor of financial management at IESE.

The report argues that the source of this superior performance is a set of distinctive organizational capabilities that distinguish the top private-equity performers from both their public and private rivals. Three capabilities, in particular, are especially important:

- *Networked Access:* extensive networks with industry insiders in the sectors where the private-equity firms operate.
- *Domain Expertise:* specialized industry-specific knowledge and expertise.
- *Fast Operational Improvement:* the capacity to implement improvements quickly that turn around their portfolio companies.

Two scenarios for the future

As for private equity's future, there are two possible scenarios. The first scenario is that the capabilities of the top performers will turn out to be the source of sustainable competitive advantages that drive the consolidation of the private-equity sector.

The second scenario is that the firms will simply define a new and higher standard of performance and, as public companies and other private-equity firms learn how to copy these capabilities, it will stimulate a new round in the global competition for capital.

However the future plays out, several factors - ample equity capital, the continuing availability of debt and a focus on creating fundamental value - suggest that private equity is here to stay.

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