The future of private equity

November 16 2009

Although global private equity markets have fallen on hard times, reports of their imminent demise are greatly exaggerated. So says Steve Kaplan, a widely recognized authority on entrepreneurial finance and corporate governance and top-rated business school professor at the University of Chicago's Graduate School of Business.

In a July 2009 interview titled "The Future of Private Equity" now appearing in the *Journal of Applied Corporate Finance* (Volume 21, Number 3), Kaplan concludes that while PE may be down, it is far from out. The increased operating capabilities of the best PE firms together with their corporate governance and financial management expertise have enabled them to establish private equity as a "permanent asset class."

From KKR's $30 billion purchase of RJR Nabisco in 1989 through the high-water mark deals of 2007, and the nearly record-breaking $180 billion raised by U.S. PE firms in 2008, the increase in capital available to the industry has been astonishing. "And even now, in July 2009, the total capital committed to private equity as a fraction of the value of the stock market continues to be at or near an all-time high," according to Kaplan.

But with over $400 billion in loans coming due in the next three to five years, just how will highly-leveraged PE portfolio companies fare? Better than you might expect, Kaplan predicts. Despite the current economy and financial markets, Kaplan expects default rates on PE deals to be lower, and recoveries to be higher, than most observers now fear.

Although many of the deals in 2006 and 2007 will turn out to have been overpriced and overleveraged, the cost of reorganizing troubled PE portfolio companies should be relatively, especially when viewed against the increases in efficiency and operating value created by the transactions.

How do we prevent the wave of overpriced deals from occurring again and avoid the boom and bust cycle that appears to have become a recurring pattern in the industry? The main possibility explored is that the limited partners and lenders in PE deals insist on larger commitments of equity by the financial sponsors to their own transactions and funds. This would help rid the industry of less reputable PE firms—those that Kaplan refers to as "the transients"—that have done the most to give the industry a bad name.

More information: www3.interscience.wiley.com/jo … l/122663735/abstract

Source: Wiley (news : web)