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Private Equity Paranoia

Some market commentators say the eye-catching growth of the private equity business may have oversaturated U.S. capital markets, potentially harming investors and increasing the risk of business failures, which could trigger a recession. Various reasons are offered for these woeful predictions. One is that intense demand from buyout funds may push equity prices to

unsustainable levels, which could result in a collapse that would adversely affect pension funds, foundations, and academic endowments, as well as individual investors. Others worry that shifting huge portions of the corporate landscape into private hands, loading formerly strong companies with excess debt, heightens the risk that those companies will fail. Yet another fear is the destruction of shareholder value, as buyout funds team with corporate management to take companies private, reaping large payouts at the expense of the former public shareholders.

I think that gloom-and-doom scenario is dead wrong, and that the private equity business still has plenty of room to grow without upending our economy. True, private equity investment has grown dramatically, even exponentially, over the last five years. Blackstone Group raised $15.6 billion last year, then added $5 billion through a rights offering this year. Texas Pacific Group raised $15.2 billion in 2006, while Apollo Management and Bain Capital raised $10.1 billion and $10 billion, respectively.

> Forget the gloomy predictions. The market still has plenty of room to grow

BLACKSTONE'S RECENT $39 BILLION acquisition of Equity Office Properties Trust showed that few deals are too large for this new breed of investor. Now if reports that Blackstone—which made its name taking public companies private—is planning to take itself public prove true, few could deny that private equity is primed to become a fixture of the financial landscape. Yet while the sums amassed by private equity players aren't inconsequential, they don't signal an industry out of control. Nor do they tell the whole story.

U.S. private equity firms raised a record $215.4 billion in 2006, according to the Dow Jones *Private Equity Analyst* newsletter. Since 2000, private equity investors—mainly pension funds, endowments, and other institutional investors, along with some individuals—have committed $555 billion to private equity funds, with $322 billion of it still to be invested, according to Wachovia Securities. But the numbers, big as they are, must be kept in perspective.

For example, that $322 billion in private equity capital is just slightly more than the equity market capitalization of Microsoft ($302 billion) and less than that of ExxonMobil ($425 billion) and General Electric ($379 billion). Of course private equity funds typically leverage their equity capital with debt, so the total purchasing power of private equity's $322 billion might be as much as $800 billion. That roughly equals the total enterprise value—market equity capitalization plus debt, minus cash—of GE ($748 billion) and ahead of No. 2 Citigroup ($698 billion). In other words, the private equity business has about the same economic muscle as GE's Jeff Immelt or Citi's Chuck Prince.

Indeed, the $322 billion in private equity is equivalent to about 1.6% of the $20.1 trillion in total equity value of all the companies traded on the principal U.S. exchanges. Private equity's piece of the pie is even smaller measured against the $54.1 trillion net worth of U.S. households and nonprofit organizations—the individuals and entities that ultimately own all financial, real estate, and other assets. While not exactly chump change, the buying power of available private equity money pales by comparison.

Private equity acquisition prices have indeed increased as the economy recovered from recession, rising from 6.1 times EBITDA (earnings before interest, taxes, depreciation, and amortization: a common measure of underlying earning power) in 2001 to 8.6 times in 2006 for large deals. Debt financing has made up most of the difference, with equity's share modestly declining. But acquisition multiples paid by public companies remain higher than those paid by private equity acquirers, frequently exceeding 10 times EBITDA in such deals as Express Scripts' acquisition of Caremark Rx (13.2 times). This certainly doesn't suggest that private equity funds are overpaying, nor that growth in private equity is propelling valuations generally to unsustainable levels. Instead I believe private equity can profitably—and safely—expand for many years to come. ■

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