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How private equity can help its case

By **ROBERTO QUARTA**

Hardly a day goes by that we do not read of yet another astonishing private equity record being broken - largest deal, largest fund, highest return, largest leverage.

Yet this scaling of the asset class brings its own challenges. Sellers have become savvier, humbled by selling too low to private equity buyers. The sheer weight of funds in the industry is driving up prices. This combination means that the industry will struggle in future to maintain the stellar return levels seen in the past.

Scale also brings reputational challenges. A senior German politician branded the industry (loosely, though tellingly, bracketed with hedge funds) as "locusts". Regulators have started to take a keener interest in the industry, as have policymakers. Finance ministers see a chance to increase the tax take, while others argue that increased power requires greater transparency and accountability.

How will private equity meet these twin challenges - sustaining returns and reputation - in the years ahead?

The industry will have to spend more time explaining itself - and not just to existing investors. This process is already under way and will no doubt go much further still. The price of success is that private equity will become a little less private.

But the case for private equity goes well beyond public relations. It rests on the simple proposition that private equity ownership is a force for economic good because it helps build better businesses - ones that deliver better products and services, generating more sustainable employment, allowing for bigger profits and higher taxes. In short, we make money because we make businesses better.

Whatever challenges private equity may face at present, there are a lot of businesses, especially in Europe, that need improving. They can and will benefit from the structural advantages and disciplines of private equity ownership.

Private equity can unquestionably be an engine of constructive change, a form of transitional ownership that facilitates corporate restructuring as unwieldy conglomerates divest non-core businesses.

Properly done, it can change the way businesses and people perform, transforming mediocre operations into top performers. An example would be Rexel - an electrical goods distribution business bought from Pinault Printemps Re-doute two years ago by Clayton Dubilier & Rice and partners. It was in good shape then, but PPR was a luxury goods business where Rexel was always going to be unloved. It is now the undisputed world leader in the industry, helped by the new ownership, which has acted as a catalyst for constructive change in a way that was simply not possible before. There are no losers here.

This ability to improve underlying operating performance, as well as the growth profile, of investee companies is not just something that plays well in the court of public opinion. It is also increasingly likely to be what investors seek out as the most probable guarantor of superior performance over the economic cycle.

Recent years, of course, have been very benign for private equity - the combination of accommodating debt markets and rising equity markets has certainly helped boost returns.Few believe, though, that these conditions can persist indefinitely.

The ability to improve operating performance in investee companies is a key competitive advantage. Perhaps it is no coincidence, given where we are in the industry cycle, that firms are increasingly keen to lay claim to an operating capability.

This is not to say that CD&R, like other private equity firms, does not apply financial leverage to its investments as part of the model to deliver superior returns for pension funds, endowments and other investors. It does. But that is only part of the story. Historically there have been three key elements which have mitigated risk with highly leveraged buyouts: detailed due diligence, intensely negotiated and detailed contractual arrangements, and absolute control in the ongoing entity for the investor.

But this process takes time and a cash-rich industry is increasingly under pressure to invest its funds. In part, this is what lies behind the rise of club deals, where investors band together to buy larger businesses, like the recently announced Dollars 33.6bn purchase of HCA, while spreading risk.

Of themselves, these are not good or bad trends. But they do represent moves away from the core buyout model of investing that was at the heart of private equity investing, and may involve embracing more risk than appears to be the case at present.

So while the relatively young private equity industry still enjoys great opportunities, particularly in Europe, it is also experiencing growth which is posing fresh challenges, not least to the way the industry operates.

It seems increasingly likely that if private equity is to sustain the returns that generated growth in the first place and maintain its public "licence to operate", we will be hearing more talk of industrial skills and a little less about the magic of debt markets.

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