
*?Peter Cook is the author of the* ***?Is That True??*** *•series of articles, which help explain the many statements and theories circulating in the mainstream financial media often presented as ?truths.? The motives and psychology of market participants, which drives the difference between truth and partial-truth, are explored.?*

Each year, private equity powerhouse Bain & Company produces a comprehensive review of the private investments sector. Private investments are thriving because they generate returns that beat public stock market investments, which they have done over multiple time horizons in the past. Institutional investors have noticed.• Private investment funds raised $700 billion in each of the past two years.• Per McKinsey, the assets of the private investment industry have hurtled above $5 trillion. ••But the industry also has a problem: it is pulling in more capital than it can invest.• As of


1.7 trillion) is sitting idle.• The ich focuses on buying inflows into an asset class that already is having trouble investing money quickly enough? Private equity investments can only continue to beat public equity investments if some combination of the following variables is present:

1. *Initial valuation is low enough*
2. *After an investment or buyout, operations can be made more efficient/profitable*
3. *Leverage is employed to magnify the gains from improved efficiency/profitability*
4. *Exit valuation is high enough*

Private equity firms can only have a direct impact on the second variable, while the first and fourth variables are set ng helps set market valuations).• The ing at the first variable, valuations for dea er than in 2010-2013, as shown below.

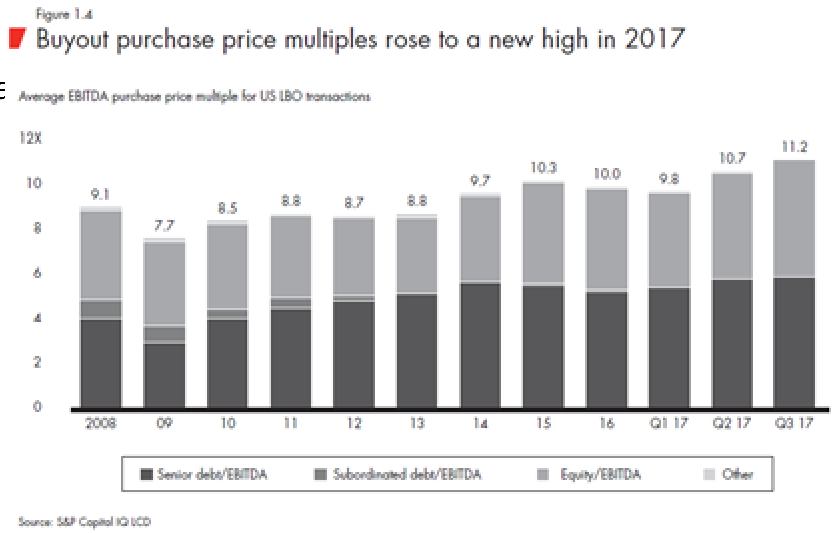


Figure 1.4
Buyout purchase price multiples rose to a new high in 2017
Average EBITDA purchase price multiple for US LBO transactions
Source: S&P Capital IQ LCD

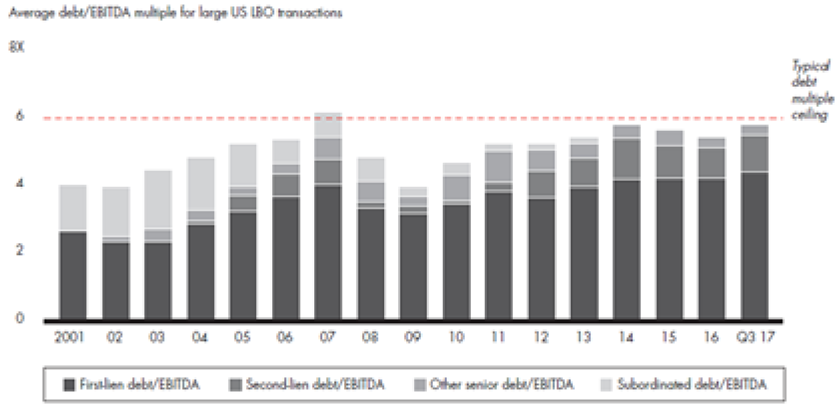
The Bain study included a screening tool, attempting to predict how the wall of idle buyout cash might be invested, given today?s high valuations.

> *?To gauge the potential for public-to-private activity in the year ahead, we looked at the universe of U.S. public companies with enterprise value up to $50 billion (a level beyond which a take-private transaction becomes impractical). We identified close to 800 companies trading at multiples of nine times EBITDA or below, making them relatively attractive targets. Screening them further based on potential for revenue and margin expansion, we ended up with 72 US public companies that seem ripe for conversion. For large GPs eager to put big sums of capital to work, the public markets are likely to offer a fertile field in 2018.?*

Summarizing, private equity buyout firms, which have plenty of dry powder and the motivation to use it (fees), are effectively setting a floor valuation for dozens of large U.S. public companies.• We have previously discussed how traditional central bank QE and corporate QE (buybacks), plus the high-frequency traders that front-run them, have boosted stock market valuations.• Private equity investors, lacking good investments in their traditional space, are yet another eager buyer waiting in the wings, although in contrast to the other types of buyers, there appears to be some constraint on the valuations they pay. ••The main point is that equity prices do not operate in a vacuum.• Money can be created out of thin air by central banks, borrowed from the banking system, easily converted from one currency to another, or moved from one asset class to another. High valuations can also be explained, at least partly, by the availability of plentiful leverage.• Although still below the high set in 2007, leverage multiples have been bumping up against a 6x limit that is thought to attract the scrutiny of banking regulators, as shown below.• If leverage is limited while valuations are rising, then more equity must be injected to get the deals done.• But a higher equity component in the

Figure 1.3

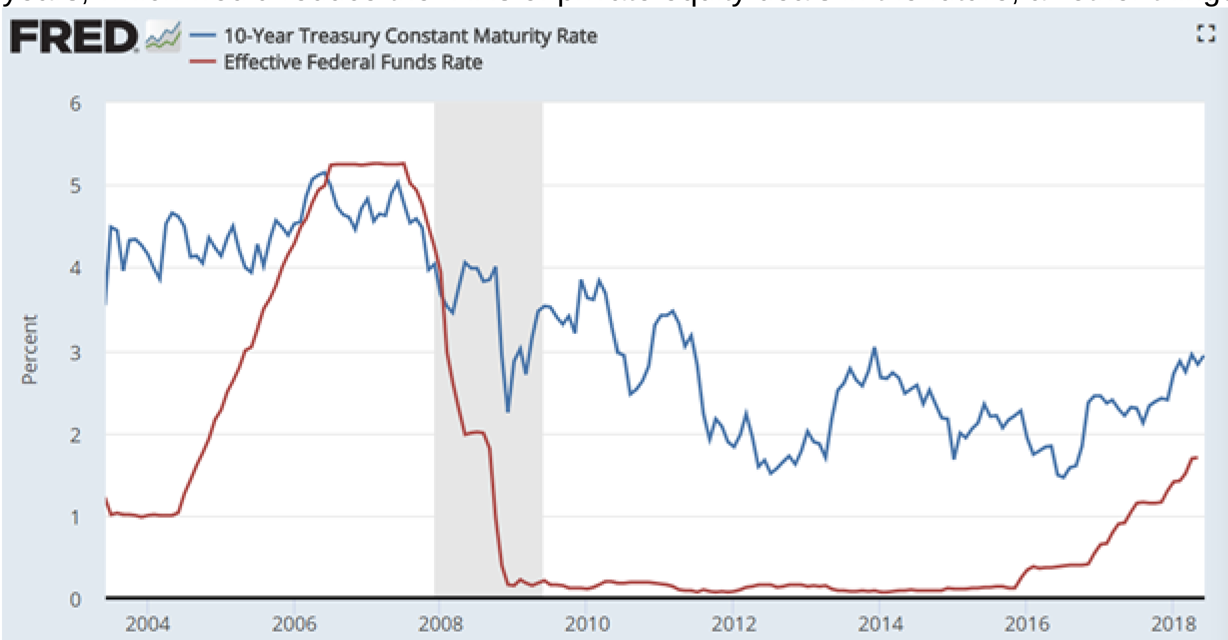
Ample supplies of inexpensive debt have led to higher leverage




Note: Large LBO transactions defined as issuers with EBITDA greater than $50 million
Source: S&P Capital IQ LCD

equity.

The cost of leverage is yet another factor in successful private equity investing.• One big difference between 2007 and recent times is the level of interest rates.• A leveraged private equity deal can be financed at short-term interest rates or long-term interest rates. •Interest rates are much lower today for either type of borrowing, as shown below.• But if the Fed is to be believed, the direction of interest rates is higher in coming years, which would reduce the IRRs of private equity deals in the future, all other things equal.




# Summary

There is a surplus of money aimed at the private investments sector, as evidenced by the fact that $1.7 trillion is now committed but not invested, and that number has been growing each year. Of the $1.7 trillion of dry powder, $600 billion is aimed at the buyout sector, which can only be successful with a combination of buying at a low valuation, financing buyout deals with cheap and plentiful leverage, wringing out operational efficiency gains, and selling at a valuation close to what it bought at. Yet today, valuations are high, interest rates are rising, and leverage ratios are already at a regulatory limit.• In addition, the percentage of equity required to get deals done is rising, which lowers the IRRs that can be achieved in future deals.• Even with those headwinds, the Bain screen shows that dozens of large U.S. public companies could be bought out, which places a floor those companies? stock prices.• Investors in private equity buyout funds appear to be placing great faith in the ability to create operational efficiencies and/or even higher valuations in the future. Come to think of it, so do investors in the U.S. stock market.