

So What's The Big Idea! - 27 July 2007

There are major changes afoot in private equity. While investors in public markets have sent share prices swooning over fears that a shift in the tax code will diminish private equity corporate takeovers, smart private investors are already beginning to shift gears in a search for future avenues of profit. Follow their thinking and see where the trail goes.

“Win Valuable Prizes!” “Collect The Whole Set!” “Trade Them With Your Friends!”

By Clark Winter

In the late 1970s, when Keith Haring was putting up his graffiti art on New York City subway advertising-poster holders, an impassioned Magic Marker-scrawled plea appeared one day on the tiled wall of the southbound Lexington Avenue line, at the 77th Street station. It read, “Save Soviet Jews.” A day later, beneath that message, three different hands had scrawled the following rejoinders: “Win valuable prizes!” “Collect the whole set.” “Trade them with your friends.”

While mordantly funny and in impossibly poor taste, the lines make a certain sense today if you ask the question, “What is the future of private equity?” Think back to late 2001, when stock markets had lost between a third and half of their capitalization, when trillions of dollars of equity value had been wiped out, and when market volatility was near historic highs. No one could say for certain what was going to happen next. But in 2002, a combination of falling interest rates and changes in the capital gains portion of the tax code not only made money cheap, it provided an incentive for the smartest investors to review and rethink the damaged stock markets in front of them. The result was the rise of private equity, where some of the most damaged companies, those most in need of restructuring and revamping, were temporarily retired from the market by being taken private.

The subsequent boom in private equity – lots of companies to pick through, plenty of cheap money to pay for them, lots of investors lining

up to take them on – created a bonanza for private equity firms, and made their leaders among the wealthiest people on the planet. Call this the “Win Valuable Prizes” stage of private equity. Politicians have squawked at this almost embarrassing accumulation of riches, and have threatened to make changes in the tax code so that private equity gains would be taxed as ordinary income, at a maximum rate of 35%, instead of as a capital gain, taxed at 15%. Investors, fearing that such changes will destroy the incentive for private equity firms to do takeovers, have sent stock markets into a swoon.

Investors ought not worry. The takeover business is not about to end anytime soon. While private equity managers and their clients have gotten almost embarrassingly wealthy, their work has also helped to make the stock market’s very recovery possible. How so? By taking the most troubled companies off the market, they have helped lower overall market volatility. It is low volatility that the market is counting on for gains, not takeovers per se.

If you don’t believe me, take a look at movements of the VIX, the Chicago Board Options Exchanges measure of market volatility, also known as the “fear gauge.” On Sept 20, 2001, while the World Trade Center was still a smoking pile of rubble, while the Pentagon had an enormous crater in its side, and while Americans were still in shock and attempting to come to grips with the tragedy of Sept. 11 and the fears it provoked of what might come next, the VIX rose to what would be its highest level this century, 43.74. (In 1998, at the height of the Internet feeding frenzy, it rose even higher, above 45, for a single day, but since then, the VIX has generally resided in the low 20s.)

As the private equity boom swung into motion within a year following Sept. 11, the VIX began to drop, first cautiously, and then, as cheap money made corporate takeovers ever easier and less risky, with increasing speed. By the end of 2002, the VIX was back at its historical level, around 20. By near the end of January of this year, when both public and private acquisition activity looked to be on a record pace, the VIX dropped to its lowest point, 9.89, a more than 77 percent drop from its post-9/11 high. That is an enormous drop in fear, or really, a concomitant rise in investor confidence, given the knowledge that the riskiest investments have been taken off the table by private equity firms. Even in the shaky current market, the VIX has done no more than gone back to average historical levels, in the high teens to low 20s, because private equity has helped to lower overall average risk.

But that was yesterday. How will private equity make money in the future, and will firms continue to help the average investor in public markets? The answer is in the next two lines: “Collect the whole set” and “Trade them with your friends.” Already there are signs that private equity investors are moving towards the second strategy. Recognizing that it is not enough to fix a trouble company, firms such as Cerberus Capital and Carlyle Group are acquiring stakes in critical industries such as autos, telecommunications and aerospace, while

investors such as Lakshmi Mittal has begun to rationalize the world’s steel industry by becoming its largest producer. As the world continues to globalize, expect private equity firms to continue to do more of the same, as they recognize that companies cannot be fixed in isolation, and that entire industrial sectors need to be re-arranged for efficiency.

Then what happens? Once a company is set right, or even an entire industry, will the exit strategy be to resell to the public? Probably not. “Trade them with your friends” will become the best strategy, not re-capitalization in the equity markets. Here’s why. As firms and investors alike are discovering what Harvard Business School professor Michael C. Jensen calls the inevitable conflict between profit maximization and the claims made by stakeholders, companies without shareholders become more nimble and adept in their decision making. As entire industries rationalize, various private equity companies will begin to sort through their holdings and begin selling off bits and pieces that don’t make sense in their own portfolios, but might do well in someone else’s.

The “Win valuable prizes” stage of private equity is far from over. But those who can best make sense out of “Collect the whole set” and “Trade them with your friends” will be in the best position to profit from growing drivers in equity markets. ■

Clark Winter has a long history in investment management, at Morgan Guaranty Trust/JPMorgan, where he opened offices in Spain and Mexico, as CEO of Global Asset Management (now part of UBS), and as founder and president of Winter Capital International, an independent advisory firm that is now a subsidiary of the Citigroup Private Bank. He has written for *Forbes* and other publications and is the author of **“The Either/Or Investor,”** a book to be published in January, 2008. Copyright © 2007 by Clark Winter