



## Private Equity Ready to Spend

*Nearly US\$1 trillion on the sidelines*

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Private equity investors are looking for deals. The industry is awash in capital, and investors are looking for ways to spend it. At issue is nearly US\$1 trillion that is not producing any returns, and the numbers are expected to reach even higher levels.

According to Private Equity Intelligence Ltd. (PREQIN), a London-based private equity research firm, the industry is sitting on an estimated US\$820 billion in "dry powder." This capital is not committed to any investment opportunities and is free for use. The problem is that "dry powder" is not productive. Investors put money into private equity funds in order to make money; for US\$820 billion, that is not happening. To a certain extent, private equity is a victim of its own success, as the publicity of high returns attracts more capital to the industry.

Overall, the total assets managed by global private equity stand at US\$2 trillion, nearly triple the US\$1 trillion in assets under management in 2003, according to PREQIN. Global assets under management are expected to reach US\$5 trillion in the next five to seven years, representing an increase of 150 percent. Without a doubt, private equity is growing.

As new capital enters the private equity industry, the funds experience more pressure to perform. They have to find a larger number of high-quality deals. This pushes company values higher, making private equity investments less productive. The number of accessible deals thus shrinks, exacerbating the problem.

In the second half of 2007, the subprime mortgage crisis stalled private equity productivity, as funds often rely on credit markets to complete deals. This temporary setback does not appear to have quelled investor interest, though, as 52 percent of investors surveyed by PREQIN plan to maintain their current exposures to private equity, and 48 percent plan an increase. In fact, among investors surveyed specifically about the credit crunch as it relates to private equity investing, 92 percent have indicated no change of strategy and fund preference. Only 7 percent plan to change their strategies in some way, and 1 percent are unsure of what the effects will be.



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The private equity community anticipated a credit market effect of some kind, according to research by PREQIN, though no date had been pinpointed. Thus, the credit crunch that occurred in the second half of 2007 was not completely unexpected. Larger deals have been interrupted, though credit is available again for smaller and mid-sized investments. Of course, deal volume dropped precipitously in the second half of the year, but the private equity market appears to be on the road to recovery.

An embarrassment of riches is putting pressure on the private equity community. Investors seem to want more than the market can provide. What comes next? Two competing possibilities seem likely. One is a gradual decline in capital inflows to private equity markets, as investors do not experience outsized returns. The other is increased risk, as private equity funds sacrifice investment quality in favour of simply putting invested capital to work. The results of this second case are difficult to forecast, though one would expect the number of losing investments to increase. Higher risk would suggest, though, that there would be a larger number of unexpected winners, as well.

PREQIN does not expect a shortage of deals, even in light of the large amounts of "dry powder" on which the industry is sitting. Capital is being accessed quickly, the research firm says, indicating that there is no shortage of investment opportunity in the market. Further, PREQIN indicates that the private equity industry is still small, occupying only 3 percent of the US\$59.7 trillion capitalization of global stock markets (as determined by the World Federation of Exchanges).

The private equity industry has to produce. Conditions are becoming challenging, but the availability of capital certainly isn't the problem.