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The Unsettled Environment for Private Equity

On behalf of the institutional investor, the subscribers, members of the advisory and editorial boards, and authors that have contributed to *The Journal of Private Equity*, we thank the founding editor, Dr. James E. Schrager, Clinical Professor of Entrepreneurship and Strategy at The University of Chicago Booth School of Business. Over the past 15 years, Jim strategically guided the content of the journal to expand its audience and make it the most respected journal of private equity and the leading place where academics and practitioners come to exchange ideas about the venture capital and equity buyout worlds. In Jim's own words, "We highlight what the future holds for our privately owned enterprises, with a review of trends in all fields that impact our activities. We have a special interest in things international as we know of no other publication that realizes private equity happens all over the world. Reading each quarterly issue enables our subscribers to get an unparalled view of today, tomorrow, and what lies beyond." A sincere "thank you" to Dr. James E. Schrager for a job well done: We wish you the best in your future entrepreneurial adventures.

As wealth accumulation is gradually recovering from the recession of 2007–2009, investors are slowly refocusing attention on private equity. Currently, an estimated 1,700 plus funds are competing to raise an estimated $700 billion, of which slightly more than 10% is for buyouts. Fundraising levels for private equity companies are showing only modest signs of improvement through the third quarter of 2011. Even so, the average time it takes for private equity firms to close their fund shortened from slightly over 20 months in 2010 to just below 15 months in 2011. (See charts at back of this issue.) LP investors continue to express an interest in emerging market opportunities, particularly Asia with a preference for China and India.

In the venture capital space, signs of improved fundraising earlier this year quieted during the third and into the fourth quarter. Despite the global jump in research and development spending to $550 billion this year, cash-rich corporations—particularly in the U.S.—are increasing their investment in venture capital to tap innovation inside small companies. U.S. corporate venture capitalists invested almost $2 billion in about 20% of all new ventures.

The common cause of the softening in activity is the concern over growing global political and economic uncertainties including fears of a stall in the U.S. recovery and of a possible European recession in the fourth quarter. This has been compounded by rising concerns over the seeming inability to resolve European countries' debt servicing problems, particularly in Greece and Italy. Finally, there are growing fears of European banking problems particularly for banks in France, United Kingdom, and Germany related to nonperforming loans to these weakened economies. Meanwhile, new lending activity by banks in the U.S. and Europe remain neutralized because of the increase in capital requirements and in provisioning for high levels of nonperforming loans. This challenges bank liquidity build up and renewed lending and appetite for risk assets. Thus, investors' short-term objective continues to be primarily a flight to safety in U.S. Treasury securities.

Global private equity exit activity expanded (from a low in the 4th quarter of 2008) to record levels in the 2nd quarter of 2011 at near $130 billion. It has since slowed to near $100 billion in the 3rd quarter. Even so, global private exit value for 2011 will exceed that of 2010 and serve as a significant source of generating liquidity. Nevertheless, the value of "dry powder" continues to decline from the 2008 peak. In the U.S., private equity exit value has also been rising since the low point in 2009. The most vibrant types of exits were corporate acquisition and secondary buyouts with very few IPOs. Valuation multiples globally and in the U.S. continue to show improvement while capital market investors are increasingly suspicious of the pricing of companies as private equity portfolio company inventory is at record levels—although rising more slowly during the past three years.

The final issue of 2011 of *The Journal of Private Equity* focuses on a broad range of articles dealing with management issues covering various aspects of the private equity business. The first article, because of its timeliness, by Gary Gibbons and Heather M. Stone, examines the changes in the regulation of private equity in the Dodd–Frank bill. Under this bill, most private equity managers will be required to register as investment advisors. A second timely article, by Harlan Platt, Marjorie Platt, and Sebahattin Demirkan, examines the underlying reasons for stock price volatility and illustrates the impact of terminal value estimates.

The next section contains five articles that analyze various aspects of private equity investment strategy and application. The first article, by Marcos Escobar, Peter Hieber, Matthias Scherer, and Luis Seco, looks at portfolio optimization in a multidimensional structural-default model with a focus on private equity. In the second article, Feng Dong, Nicola Chiara, Nakhon Kokkaew, and Jialu Wu, study the stochastic optimization of capital structure in privately funded infrastructure projects that are public–private partnerships. They present a new model and identify an optimal mix of equity, debt, and mezzanine capital by incorporating stochastic dynamic programing. The third article, by Joseph W. Bartlett, spells out an assembly line business model for a company tracing a new idea from new venture to IPO that increases the after-tax returns to the company and investors. Next, Hisanori Fujiwara and Hiromichi Kimura examine the performance of 32 independent and corporate venture capital firms investing in biotechnology and medical device companies and track the incentive system to illustrate the role it plays in influencing active investment behavior. Finally, Joseph Calandro, Jr., looks into the turnaround value and valuation in presenting a case study of reassessing Scott Paper Company. He demonstrates how conservative exit planning mitigates execution risk for the incoming turnaround expert.

Finally, Benedict Kwon examines the tax structuring for foreign pension fund investment in U.S. real estate funds and how to ensure that it is an efficient tax structure that maximizes returns to the investors.

F. John Mathis
Editor