The Pulse of Private Equity – 2/23/2015

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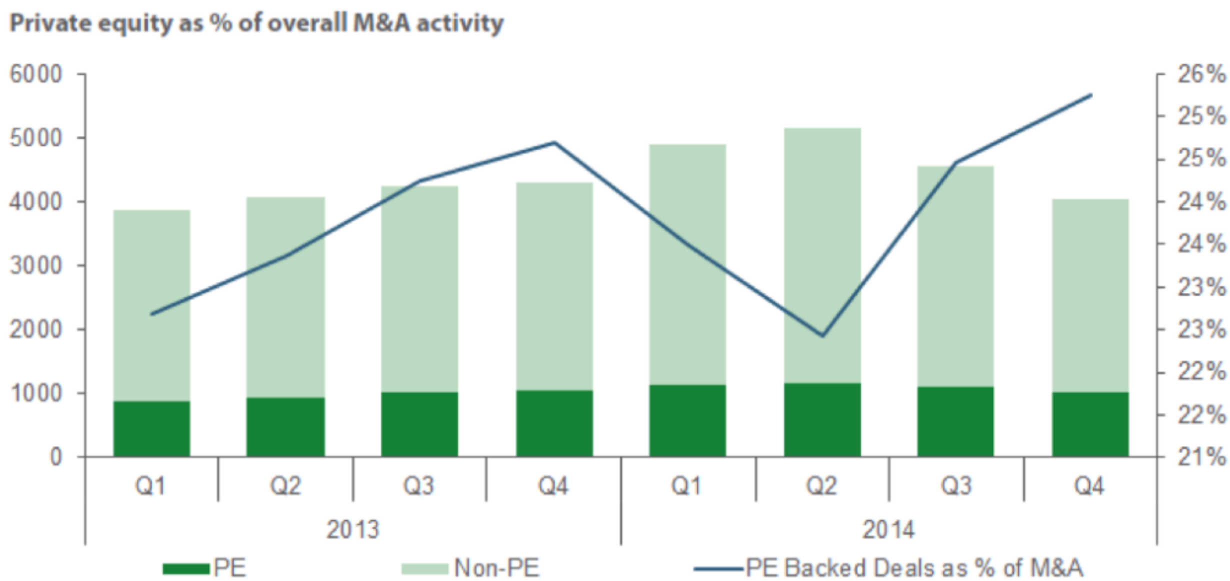
The PE-strategic battle continues

PE firms and strategic buyers have been waging a deal war the past few years. Both sides have complained about the advantages the other side has, but most PE executives will readily admit that strategics have had their number recently. Cheap and abundant credit isn't getting PE firms very far when they're going head-to-head with ambitious strategics, which are shoehorning synergistic assumptions into their bids and stretching acquisition offers beyond what any disciplined PE firms can match. The public markets, once a PE hunting ground, have turned barren for PE buyers. Stock prices aren't just nominally high today – growth projections are baked into share prices, leaving PE firms less wiggle room to generate outsized returns. Entry prices are critical for PE but often an afterthought for strategics, which have lower hurdles to jump for short-term ROI and can average down their deal multiples thanks to those synergies.



It will be interesting to see what happens once interest rates rise. Theoretically, PE firms will be on the short end again – either they'll be forced to pay more for their loans, dampening returns, or they'll need to reduce the sizes of their bids and lose some of their competitive firepower. Another possible scenario could actually benefit PE – because current stock prices include those growth expectations, higher interest rates could spook the markets a bit and bring valuations back down to earth. Listed corporates would lose some of their buying power and competition would level out somewhat in PE's favor.

In all likelihood, though, a modest rise in interest rates won't be enough to reverse current market conditions. Strategics are fighting hard to gain market share through M&A, and they haven't shown much hesitation with valuations when synergies are involved. Interest rates aren't bothering them much. The bigger wild card this year is corporate confidence levels, and if strategics can maintain their mojo going into 2016 and beyond.