



Land that time forgot

The idea that big buy-out funds can keep growing doesn't make sense, argues **Jon Moulton**. But then again, he thought that 10 years ago, too

I started in private equity in the 1980s, running two of the largest funds in the market at that time – a £25m venture fund and an £80m buy-out fund. For anyone sharing my interest in inflation, multiply by three to put that into current money.

Nowadays, a £5bn fund does not get you into the top 10 venture funds. Top 10 buy-out firms manage more than £100bn. Funds of these sizes present new challenges, especially in the buy-out market. If you manage a £20bn fund, say, you'd likely want to end up with at most 20 investments, averaging £1bn. Where is the prey, the target companies? If you're chasing public companies in the UK, there are perhaps north of 100 conceivable targets in the FTSE 350. There are at most 50 targets of adequate size in the UK's private company market. Even the US market is finite: perhaps 500 desirable listed targets and 200 private businesses meeting those size criteria.

Fresh meat

It isn't easy to arrive at exact numbers. Companies may be unfeasible targets for a wide range of reasons. Investment companies and banks, for example, don't make good leveraged buy-outs (LBOs). Russian ownership has recently become a criterion that would see a business removed from a target list. And venture capital can generate fresh targets, so defining the size of that market is not feasible.

More than a decade ago, I was pointing out that we were approaching limits to the LBO industry. I was exceptionally wrong – the industry at the large end has prospered mightily since.

I used to give a presentation that at least I was very fond of. It featured the then LBO kings' heads attached to dinosaur bodies, some amusing sound effects and an explanation of what happened to dinosaurs. They started off small, but the environment favoured them over their competition, so they grew in size. As they got bigger, they began to eat smaller dinosaurs. Progressively, they had to start eating each other after they'd gobbled all the

other prey. Palaeontologists have established that T-Rex ate other T-Rex. As a consequence, smaller, more agile and smarter animals took over as their time came. End of analogy.

Add-on acquisitions have become essential to deploying a fund. The danger of a shortage of prey is that add-ons increasingly become essential to investing the fund and getting to the next fundraise; necessity will not necessarily lead to value-adding consolidations.

Secondary buy-outs – now half of private equity exits – have always had a whiff of cannibalism about them to me. There's a limit as to how often a lemon can be squeezed, but the LBO industry would be a lot smaller if these deals were not being done. A virtuous circle of increasing capital for LBOs has helped drive returns upwards and generated ever-greater volumes of investors – ignoring the warnings about past performance not being a guide to the future. The converse will one day apply.

Road to extinction?

Private equity firms have started to buy competitive managers. They have also had to move to new investment strategies to maintain profitable growth. The managers, as well as some of their investments, are well along the route to becoming conglomerates. More and more are themselves listing.

Listed conglomerates on both sides of the Atlantic bought assorted companies using a lot of debt. Helped by acquisition funding, they often grew well, but mostly failed, as the lack of commercial logic became apparent in debt servicing issues. And conglomerates, too, used to buy each other. Ironically, their break-ups provided a huge amount of deal flow for the early private equity industry.

There are not a lot of differences between conglomerates and LBO firms. Both started in the US and came to the UK. The chief distinctions are deal-by-deal liability isolation and explicit exit timetables for buy-out funds. The large LBO funds have to follow increasing corporate governance and environmental, social and governance rules, so the benefits of being private have been eroded. With secondary trading growing steadily, convergence with the public markets has continued.

The dinosaurs became extinct and conglomerates did too. Large PE firms? Well, I've been wrong before...

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