9 Trends for 2013

Private Equity and Investment Banking

axialmarket

Introduction

The last year was like most election years - tentative. Deals picked up in the summer and early fall, but then fell dramatically after the election. It appears we're right back where we started, as uncertain as ever.

We decided that it would be good to take a quick look at 9 general trends that will affect private equity next year. While there are many others affecting individual industries - like shale growth, commodities fluctuations and the Affordable Care Act - we're saving those for a separate report. Here's what to watch for in 2013.

Government

“Risk has become much less predictable than it used to be because most of your risk is now based upon the level of government intervention.” – Will Deitrick, New Oak Capital

Trend #1: Fiscal Cliff & Tax Changes

The fiscal cliff is a whole series of taxes and cuts that will go into effect January 1 if nothing changes. The latest news seems to indicate that a compromise will be struck, but with politicians nothing's done until it's signed.

If nothing changes, we'll get:

- Capital Gains moving from 15% to 20%
- A new 'Investment Income Tax' of 3.8%
- Dividend Rate moving from 15% to 39.6%
- Government Spending cut by $110B per year

Other changes to watch in 2013:

- Corporate Tax Rate Proposals
  - Flat 28% tax, few deductions
  - Carried Interest would be eliminated

Trend #2: JOBS Act Implemented

The JOBS Act was passed into law in April, but many of the SEC rulings on the Act still haven't gone into effect. With Mary Shapiro's recent resignation, all signs point to 2013 being the year when the Act goes live. While crowdfunding seemed to garner the most press, these are the changes that affect PE most:

- Emerging Growth IPOs: Less than $1B in revenue removes most of the reporting requirements - lowering difficulty of being public.
- Regulation A+: The exemption size for Reg A+ transactions, which are basically IPOs exempt from SEC registration, has been lifted from $5M to $50M
- General Solicitation: Reg D private placements can now be advertised far and wide without fear of "general solicitation". However, all investors in any Reg D must be accredited, so this is really just shifting a lot of the burden to ensure compliance and accredited status of prospects.

> "Relaxation of ban on general solicitation, combined with increase in limit of private holders to 2000++, means that issuers can actively solicit investors and 'build a book' of demand for an offering."
>
> Don Carlson, Founding Partner, ForeFront Law Group

Trend #3: Moving Past Mitt

Mitt Romney's run for president caused private equity to get put under a microscope in the press like never before. The Private Equity Growth Capital Council was working overtime putting together data to show how many jobs were created by private equity to counter the perception that firms simply buy and cut. As Romney's taxes were examined, politicians seized the opportunity to jump all over carried interest.

Expect 2013 to start calming down for private equity in the press. Private equity will go back to being private in 2013, though carried interest may still be affected as part of the simplification of the corporate tax code.

PE Structural Trends

Trend #4: Dry Powder

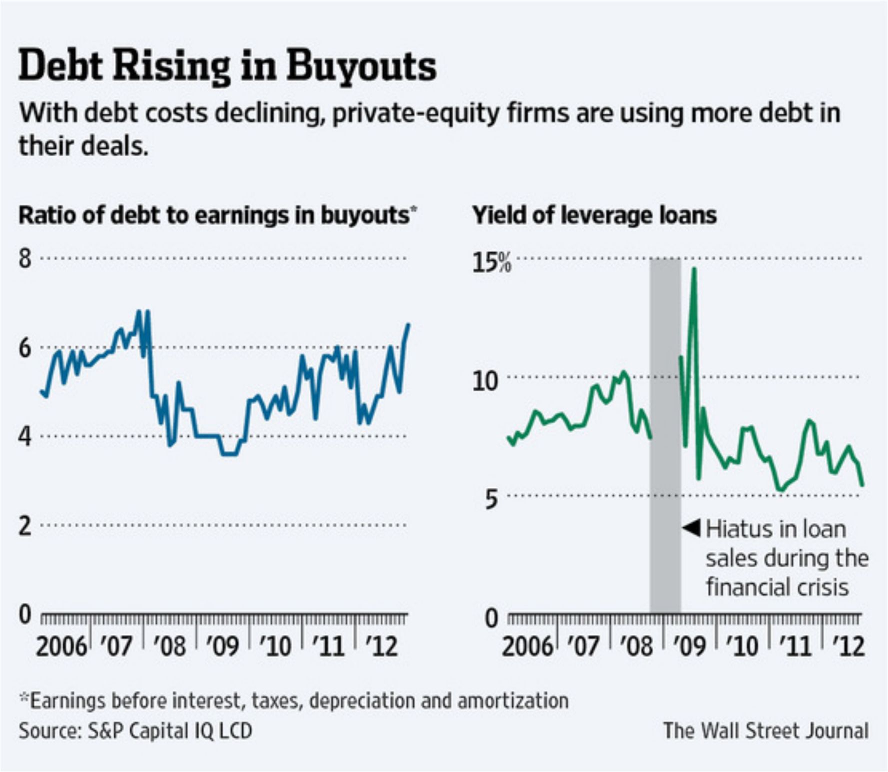
After the 2008 crisis there was a period of time when the industry didn't know if it'd be able to raise any more money. That doesn't seem to be a problem these days. In fact, according to a number of sources, dry powder is one of the biggest issues as the overhang is near half a trillion dollars. Though the pressure could be relieved if private equity groups start bringing companies from their 2006-2009 buying sprees to market, there seems to be indications that many are happy to hold them until valuations go up.

With so much dry powder sitting on the side, it appears that valuations have nowhere to go but up. In our recent survey, nearly 58% of respondents felt valuations would rise in 2013 and dry powder was one of the top issues respondents were concerned about next year.

Trend #5: More Debt Per Deal

After the crash in 2008, debt in deals dropped nearly in half. Since then it's steadily risen as a ratio to earnings, getting close to where it was in 2007. It looks like debt in deals is pushing back to the same ratio around 7x earnings on many deals as debt costs for firms are declining.

While this is great for juicing gains of private equity firms, it can also create difficult situations if things go awry - like the fiscal cliff for example. The bright spot is that they companies they're financing seem to be on more solid footing than those financed prior to the boom.



Trend #6: Fund Allocation Changes

While fund diversification – managing multiple asset classes - started full force for private equity groups when they started going public, the trend seems to be trickling down to the middle market as well. With many banks getting tighter restrictions around liquidity and short term assets - especially with Basel III and Dodd Frank being implemented - companies are seeking alternative sources of financing. This has led to a surge in SBIC lenders, more specialized lower middle market private equity groups, and others offering capital beyond generalist LBOs. Expect this trend to continue through 2013.

> ‘Stephen A. Schwarzman, the chief executive of Blackstone, bristles when Blackstone is referred to as a “private equity firm.” He has a point. The pool of money in Blackstone’s private equity arm accounts for just one-quarter of the firm’s $205 billion in assets.’
>
> \- Peter Lattman, DealBook, Dec 2012

International

Trend #7: European Fiscal Issues

In early 2012, Europe was a giant ball of uncertainty. Throughout the year, the uncertainty worsened as Greece eventually restructured its debt to the tune of around $130B. This has resulted in a number of new fiscal measures in Europe:

- Basel III - implementation isn't going perfectly, but international banks have already raised liquidity to $700B of the expected $1.5 trillion. US has opted-out of it in favor of Dodd-Frank regulations.
- ECB and other EU banks more tightly aligning rules and governance. Previously there were a few different rule structures, approval committees and places for oversight. Trying to put it all in one place.
- Social spending, austerity and corporate taxes. There have been recent issues with taxes in France as their rates are soaring as high as 75% for some individuals. As Angela Merkel, PM of Germany said recently in the Financial Times, "If Europe today accounts for just over 7 per cent of the world's population, produces around 25 per cent of global GDP and has to finance 50 per cent of global social spending, then it's obvious that it will have to work very hard to maintain its prosperity and way of life."

Trend #8: Post-BRIC Investing

Over the last few years, private equity has been investing abroad heavily in the BRIC countries (Brazil, Russia, India China). But, last year that seemed to change as new sets of countries started becoming hot for private equity investment. Terms like CIVETS, N-11 and more recently MIST have been thrown around to describe the next wave of countries to grow rapidly with good investment prospects.

While Latin America, one of the traditional powerhouses of private equity, dropped from $17B in investment during 2010 to less than $2B in the first half of 2012, other markets seem to be opening up. Funds have been raised for Middle East investments and African investments. PwC predicts that Nigeria and Egypt will join Vietnam, Bangladesh and the Philippines as some of the fastest growing economies in coming years.

Trend #9: On-shoring / In-sourcing

Though not strictly international, in-sourcing or on-shoring is starting to pick up. As companies begin to discover the long-term, hidden costs of offshoring, many are starting to bring manufacturing and service jobs back to the United States. GE, for example, recently started re-opening Appliance Park in order to manufacture their appliances in the US again.

Watch for interest in manufacturing, manufacturing assets, and training for manufacturing to start picking up again next year.

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- 5 Questions that Remain After the Election
- How the JOBS Act Changes Investment Banks
- JOBS Act Implications for Investors

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- Will Mega-Deals Relieve the Dry Powder Pressure?
- Middle Market M&A Outlook: Prairie Capital

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- Nate Suppaiah on Emerging Markets
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