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Mega-style drift

"Vanguard Feels the Lure of Private Equity," *The Wall Street Journal* reports, and you could knock us over with a feather. The Vanguard Group, Inc., built a business by buying the S&P 500 at the lowest possible cost. Now it's weighing a new business of buying illiquid investments at a necessarily not-low cost.

The fundamental source of this remarkable news is the topic at hand. In preview, we speculate that a kind of inflationary impulse may help to explain the otherwise inexplicable.

Wesray Capital Corp.'s 1982 leveraged buyout of Gibson Greetings, Inc. set the modern private-equity (née, LBO) movement on its way. Yet, today, 37 years later, a newspaper reader may be forgiven for believing that Wall Street, and the City of London, too, are somehow rediscovering what's not so current. For instance:

> "Goldman Ups Private-Equity Ante"
> —*The Wall Street Journal*, June 17
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> "Blackstone Sets Sights on Largest Private Fund"
> —*The Wall Street Journal*, June 19
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> "The buy-out boys in private equity are back to rock the stock market"
> —*Daily Telegraph*, June 22

Undervalued public companies are presumably in short supply in the 11th year of a great bull market. That being so, the odds are probably slim on a private-equity promoter's snagging just even one at a valuation that allows for a profitable future exit.

Then, too, managers of public companies pick up the newspaper now and again. They are well aware of the vulnerability of a listed corporation that has failed to optimize its balance sheet (as the p.e. promoters define "optimal") or has neglected to reduce its head count, slash employee benefits and hive off non-core subsidiaries.

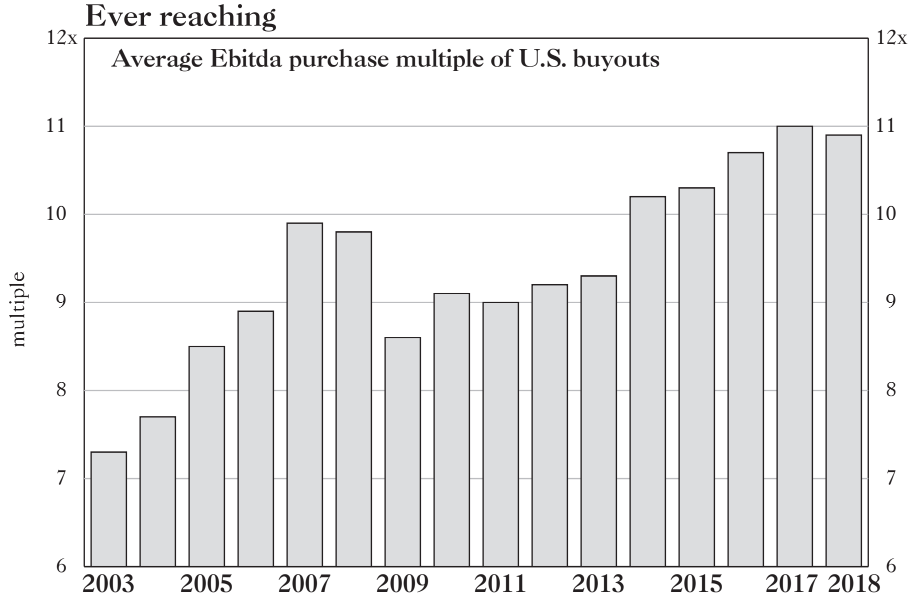
Altogether, then, the field of opportunity is much reduced since William E. Simon and Ray Chambers (the "Wes" and the "Ray" in Wesray) divulged the stunning possibilities of extreme financial leverage more than a generation ago. Then, again, as the p.e. partisans might reply, the world is less hospitable to public investing, too, than it used to be.

"In a decade marked by historically low interest rates," the *Journal* said on Monday, "return-starved pensions and sovereign-wealth funds have poured money into private markets. The move is reshaping capital markets with the number of initial public offerings in the U.S. down sharply from a high in the 1990s.

"The decline in U.S. public listings raises questions about whether smaller institutions and everyday investors are getting left out of a burgeoning source of wealth."

Or not-so-burgeoning, we would say. In the 10 years through 2018, pooled returns of all private-equity operators barely topped those of the S&P 500. You'd suppose that highly leveraged private companies would excel in a long bull market. First, there's that leverage—call it six times earnings before interest, taxes, depreciation and amortization for 2018-vintage buyouts, up from 4.9 times in 2007. Second, there's

Ever reaching



source: Bain & Co.

the fact that private-equity returns are self-reported; nobody can cross-check them by opening up *Barron's*. But public companies almost matched the privates, basis point for basis point.

"Why would you, in aggregate," posed Daniel Rasmussen, founder and portfolio manager of Verdad Capital Management, in the April 5 edition of *Grant's*, "buy disproportionately leveraged companies at disproportionately high prices in a very late stage of a bull market? That doesn't seem like a very good idea. But when you call it private equity, and take away the mark to market, suddenly it is a thing that everybody wants."

It's puzzling, to be sure. You can't swallow an entire public company without paying a premium for it, and pay the promoters do. Bain & Co. calculates that, in 2018, the average p.e. purchase multiple came to 10.9 times Ebitda, one turn higher than the average price paid at the 2007 summit.

Maybe the new private-equity boom is explicable in terms of interest rates alone. Or interest rates paired with the institutional need to conform to that which has worked. Or maybe there's another, subtler reason.

For comment, we sought out Martin Hale, Jr., founder and CEO of Hale Capital Partners, which invests in struggling public companies with an eye to ending their struggles. Hale is the kind of private-equity investor who brings price discipline to his work and who is generous enough to share his analytical approach with the attendees of a *Grant's* conference, specifically the one to be held on Oct. 23 at the Plaza Hotel in New York (—*advt.*).

"From our perch, outside of the niche areas on which we focus, such as illiquid and orphaned public companies," Hale advises by email, "a quote from Abraham Lincoln describes quite a few of the opportunities today: 'Like a soup made from a shadow of a crow which had starved to death.'"

But, says our source, what "haunts" him is the possibility that the private-equity promoters might actually be on the right track.

"Perhaps," Hale goes on, "GS et al. are gambling on what may be the only way out—continued money printing. In *The Economics of Inflation: A Study of Currency Depreciation in Post-War Germany*, by Costantino Bresciani-Turroni, there is this: 'After the war [World War I], the prices of shares, expressed in paper marks, had increased very much, but in a much lower proportion, than that of the depreciation of the currency. . . . But expressed in *paper marks*, the prices of shares seemed very high. This exercised a psychological influence on the great mass of shareholders. Deluded by the apparently high prices, even the most cautious shareholders were induced to sell their securities; and only much later, when the veil of the inflation had been torn aside, did they realize that they had made a very bad bargain!'"

It's different today, when the central bank labors to raise inflation up rather than beat it down. Still, observes Hale, "the general lesson may apply: As long as monetary alchemy continues, perhaps promulgated by the titans that profit most from it, so, too, will asset inflation." The question, of course, is, Which assets?

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