Colin C. Blaydon, director of the Center for Private Equity and Entrepreneurship at the Tuck School of Business at Dartmouth, offers this view on what is ahead for the private equity industry and whether more firms might eventually go public.

Another casualty of the large-cap leveraged buyout bubble collapse seems to be the whole idea of the public private equity firm. Even that label sounds oxymoronic on its face. The concept had its critics, even as Fortress Investment Group and Blackstone Group were successfully selling a portion of their firms to the public in 2007.

Today, those shares are trading at a steep discount to their public issue price, and earlier this month, Kohlberg Kravis Roberts said it was reconsidering its 18-month, circuitous and troubled odyssey to become a public firm.

As things stand now, no one else seems to be lined up to try it any time soon.

Is the public private-equity concept dead, or is it just a temporary victim of the meltdown in the capital markets and the recession? Will the opportunity for private equity firms to go public come back with a recovery of the financial markets, and, if so, what might these firms have to do to regain the confidence of public investors?

Private equity firms found the prospect of going public attractive for a number of reasons. For the founders and other senior partners, it was an opportunity to realize a portion of the value of the enterprise that they had created and to have another source of capital to make their own contributions to their firm’s funds.

For the firms, it was a currency to bring in senior people in new roles and even a currency to use for potential acquisitions.

For investors, it was a chance to participate in the lucrative fee stream of the private equity firms, of which they had been both impotently critical and envious: they could now invest not just in the funds, but in the firms themselves.

But these firms are not the standard firm that goes public. The value proposition of private equity firms rests on their ability to act quickly and vigorously to improve portfolio companies, to offer aggressive equity incentive compensation to management and to exercise highly focused governance and oversight. This can only be accomplished outside the glare and scrutiny of public markets.
As a result, these firms, even though public, are structured to preserve as much of the “black box” for portfolio companies as they can. Thus they offer less disclosure, and more limited governance and fiduciary commitments, to investors than other public firms.

In the good times, the markets trusted that the private equity managers knew what they were doing with their “black box” investing styles. There was an expansion of debt availability and a resulting run-up in valuations, and the early returns fueled extraordinary levels of fund-raising; the story culminated in the first private equity firms going public.

But in the current economy, investor jitters and a lack of trust make the stocks of public private equity firms vulnerable. Even in stable economic times, neither investors nor analysts understood the firms sufficiently well to forecast revenues and cash flows with any confidence. In the present environment, a lack of understanding coupled with a lack of confidence in any model that embraces limited disclosure and transparency, even if it was previously a source of competitive advantage, are a recipe that public stock markets will not support.

Private equity firms may again be able to go public in the future, if one of two things happens: Either the private equity model for the public firms has to change to include more regulation, disclosure and transparency — but if that happens, private equity firms hurt their long-term returns — or the market will recover so substantially that investor confidence will return to support another traditional “black box” private equity firm going public.

Given recent events, this latter outcome is highly unlikely. Thus, the future will most likely be made up of two groups of private equity firms.

One group will consist of large, multiline “public” private equity firms, operating with more transparency and consequently with long-run return expectations more like traditional asset management firms. The other group will be “private” private equity firms that are more focused and operating with less transparency, and thus with higher return expectations.

It may well be that some firms that went public choose to go private again, as has happened in the past with many professional service firms that went public.

Certainly, the vastly diminished market capitalizations of these firms makes that a tempting possibility. If nothing else, the industry needs labels better than the oxymoronic “public” private equity firm or the redundant “private” private equity firm.

All private equity firms, whether public or private, face the same daunting but promise-filled agenda for the next several years.

That agenda is to 1) find and make new investments in what will be an attractive valuation environment, while 2) simultaneously getting value out of the investments made during the inflated valuation environment of 2005 to 2007.
This is an opportune time for private equity firms — history shows that private equity investments made during times of market distress have produced the best returns of any vintage year.

But fixing a challenged legacy portfolio could mean that the scarce resource of talented deal partners may be spread too thinly to accomplish this dual agenda.

In any case, future activity will look substantially different for all private equity firms. It will consist of deleveraged capital structures, investment in distressed securities, restructuring for control and minority equity stakes.

Future investment activity will look more like traditional European investment structures and less like the control structures that have dominated United States private equity, and may even include participation in public/private partnerships in government-sponsored economic recovery programs.