

## **Guest Article: Private Equity - Refuge in a Challenging Environment**

By Carl Thoma, Managing Partner, Thoma Bravo

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Turbulent conditions in today's economic environment have raised comparisons with previous periods of market uncertainty. Naturally, investors are studying historic stock market performance in an attempt to gain some insight to how investments will play out given today's variables.

### **Poised to Repeat the 1970s?**

The 1970s have been recalled with greater frequency recently, as this period represented a trying time for the public equity markets. The S&P 500 finished the decade with a 1.6% annualized return. The dollar fell 35% against the yen. In the commodity markets, oil jumped from \$5.60 per barrel in October 1973 to \$28.71 in December 1979. Inflation significantly diminished America's spending power as the CPI rose 104% between 1970 and 1980.

As an investment manager who cut his teeth in private equity in the 1970s, I am at times experiencing a case of déjà vu. After graduate school, with few job opportunities in investment banking and venture capital in 1973, I found plenty of options in a thriving real estate industry. By early 1974, however, banks stopped financing real estate projects and developers began falling by the wayside. The economy crumbled about a year later, and the stock market followed suit. For a brief period in 1975, the Federal Reserve even instructed banks to stop making non-productive loans, such as those used to finance leveraged buyouts. By 1980, the prime reached 20% and inflation was rampant.

Fast forward to today and the S&P 500 is mired in a deep bear market. Inflation fears stoked by increased commodities prices, a weakened dollar, a national deficit run up by the funding of an unpopular war and now government-sponsored bailouts have all compounded comparisons with the 1970s. Although recent events have reduced inflation concerns and strengthened the dollar, these may yet be shown to be short-term changes.

If indeed today's market environment emulates that of the 1970s, the foreseeable future will remain a challenging one for investors, especially in the equity markets. It took the S&P 500 70 months to recover from its deepest lows from the 1973-74 bear market. Yet, it was in the 1970s that private equity established a foundation that enabled the industry to prosper for the next 30+ years. Let's look at how private equity, given today's challenges, can continue to generate favorable returns for investors.

### **Beat Inflation**

With the tremendous amount of national debt, I am convinced that inflation will become a problem in the long term. Private equity investors need to focus on companies that have pricing power. The ability to raise prices when the economy strengthens is tantamount to succeeding in this environment.

## **Avoid Cyclical Industries**

As we have seen from the tech bubble of the late 1990s and the recent real estate bubble, cycles occur, so why not avoid them? Look for companies that have high quality, diversified customer bases. At Thoma Bravo, we avoid cyclical and project-oriented companies by focusing on those with steady and recurring revenue streams, such as those in software.

## **Long-Term Approach**

The National Bureau of Economic Research found that the current recession began in December 2007. This recession may well last longer than 16 months, making it the longest since the Great Depression. Therefore, the ability to coach companies for long-term success is more critical than ever - what private equity can do very well. Unlike public companies that often appear caught up in short-term outlooks and quarterly earnings, private equity firms can assume a longer-term perspective on implementing the necessary strategies to secure more value. By assuming greater involvement with companies and its boards, private equity firms have an opportunity to guide companies through precarious conditions.

## **Looking Beyond Leverage**

It is no secret that the historically high multiples we saw this decade were fueled in part by cheap, accessible debt. Now however, banks have sharply curtailed lending. Forced to reduce the amount of leverage, private equity investors can still generate sufficient returns through a combination of operational improvements and strategic, add-on acquisitions.

For example, at Thoma Bravo we estimate our returns come 25% from operational improvements, 50% from synergies of tuck-in acquisitions and 25% from leverage. In addition, we finance platform deals with 50% equity and 50% debt with companies typically maintaining less-than 4X leverage.

## **Private Equity Should Do Well**

If the 1970s were any indication, we must brace for slower growth over the coming years. However, I truly believe that private equity as an asset class has the ability to manage inclement market conditions by focusing on businesses that have pricing power, recurring revenue streams and a long-term approach to growth. This is an exciting time for investing as distressed economic environments often yield the greatest returns.

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**Thoma co-founded Thoma Cressey Equity Partners (now Thoma Bravo) in 1998 and raised and managed three additional funds with almost \$2 billion of committed capital. Thoma is a past president of the National Venture Capital Association. He received his master's from the Stanford Graduate School of Business and his bachelor of arts from Oklahoma State University.**

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