



WHY THIS IS THE BEST TIME EVER TO BE AN ACQUISITION TARGET

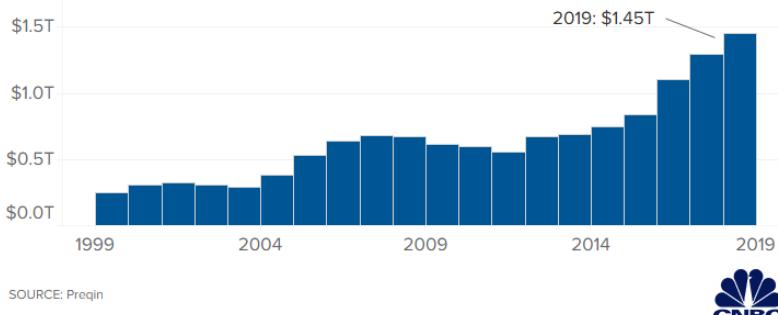
Author: Alex Trigaux

Macroeconomic forces have quietly aligned to set the stage for a potentially historic surge in private equity (PE) deal making. If you are a company that seeks a private equity investment or to be wholly acquired, there are compelling reasons to invest heavily in your brand, now, to best position it for the best-ever seller's market coming to fruition.

BOOM TIMES FOR PE FUND INFLOWS

The most compelling argument for why we are entering the golden age of mergers and acquisitions (M&A) for private companies is the simplest: There is more ready-to-invest capital sitting idle in PE firm coffers than ever before:

Private equity's cash reserves Available "dry powder" among global private equity firms



As of year-end 2019, a record \$1.45T sat in private equity funds waiting to be deployed on deals. Let's take a quick look back to September 2017 and the prevailing sentiment when there was "just" \$963B in PE "dry powder":

Investors give private equity managers their capital with the expectation that they'll make it grow. But today these managers are sitting on a record \$963.3 billion of dry powder, as they call money that they've raised but have yet to invest. The size of that pile, and the fact that it keeps rising, is making everyone antsy.

<https://www.bloomberg.com/news/articles/2017-09-01/why-private-equity-has-963-billion-in-dry-powder-quicktake-q-a>

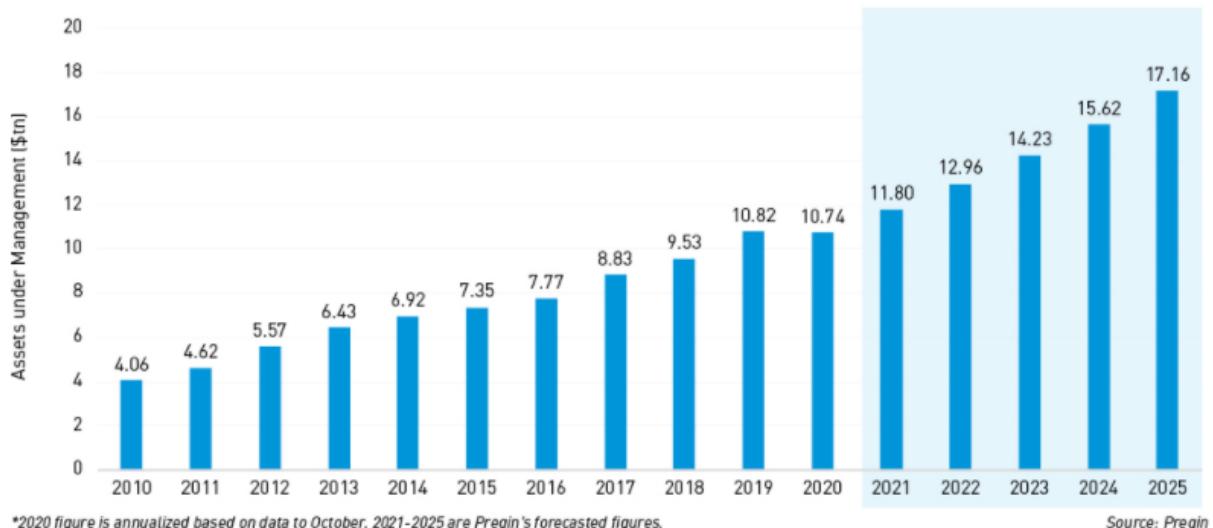
What's 50% more antsy than "antsy"? Because just over two years later, those same managers are sitting on 50% more capital than they were then, and all their investors are waiting — with different degrees of patience — for them to put that capital to work. "Dry powder" is synonymous with "investor funds earning no return." If you're antsy, and then you're 1.5x antsy, and your investors are getting restless with your inaction, you eventually have to start paying up and investing at higher valuations because if you don't, another fund will.





But is this an anomaly, a one-off surge in PE fund investment because it happens to be fashionable at the moment? Quite the opposite. This recent spike in PE fund investment is more the introduction to the real story than the final chapter:

Fig. 1: Alternative Assets under Management and Forecast, 2010 - 2025*



Private equity data provider Preqin estimates that total PE fund assets under management will increase from \$10.74T in 2020 to \$17.16T in 2025, adding almost as much fresh capital over the next five years *as existed in the entire private equity universe just five years ago.*

Let's explore why this market is on the launchpad of such significant growth.

LACK OF ATTRACTIVE OPTIONS IN THE STOCK MARKET

The primary investors in private equity funds are the whales of the investment world: pension funds (the California Public Employees' fund holds [over \\$400B](#)), university endowments (Harvard's alone currently checks in at [\\$41.9B](#)), and sovereign wealth funds (Norway's is worth [well over \\$1 trillion](#)). Due to their sheer size, such investors essentially have to deploy the majority of their capital in publicly traded stock markets — most often investing actively in U.S. markets, the most liquid of all — simply because they're the only entities that are large and liquid enough to allow them to regularly buy and sell assets in the enormous sizes they require without materially changing the price of those assets as they buy.

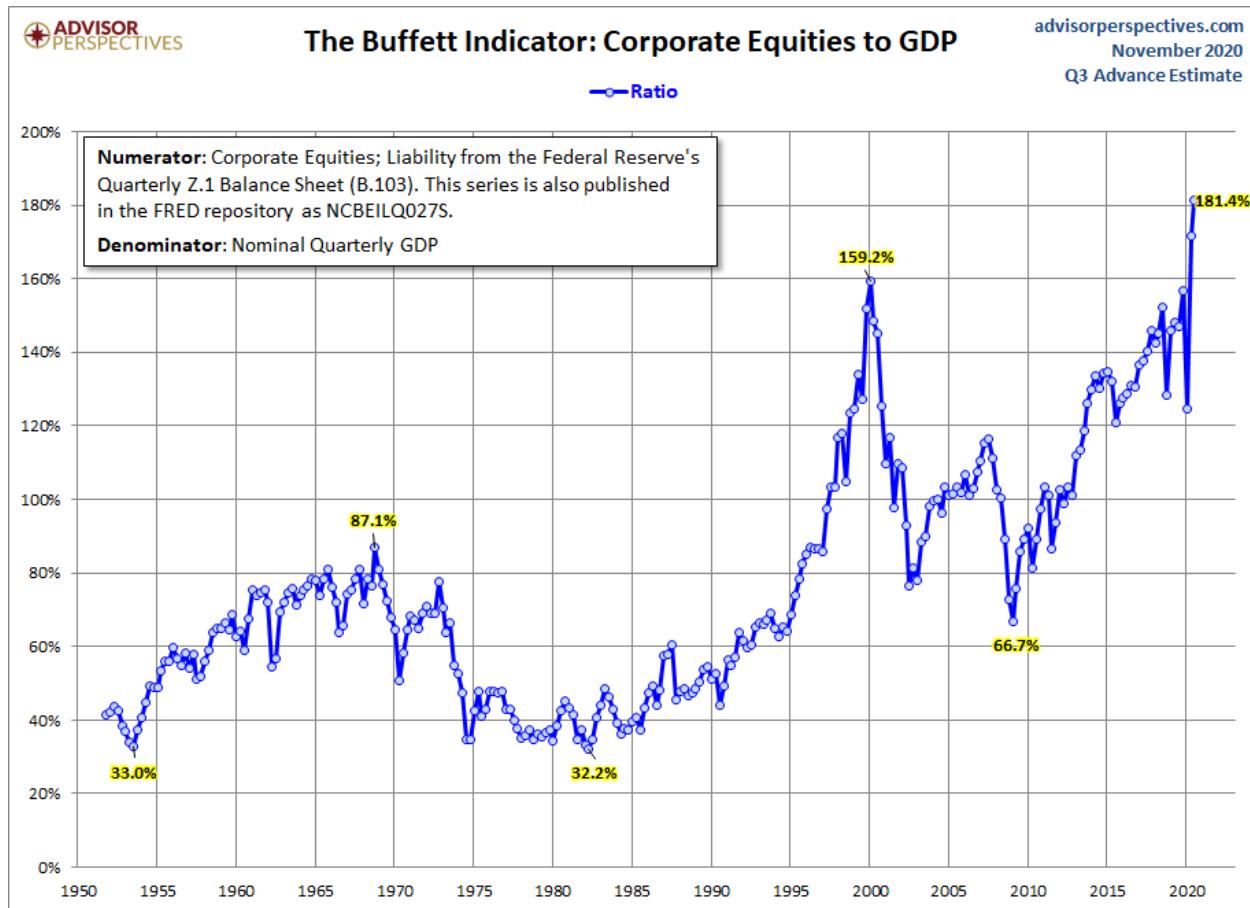
Their managers are among the world's savviest investors. They tirelessly seek out value and opportunity while weighing their need to deploy titanic amounts of capital. It is a huge problem for them when the U.S. stock market, overall, is very expensive and an unwise place for additional capital allocation.

Warren Buffett's favorite valuation metric for the overall U.S. stock market, the [Buffett Indicator](#), is exceedingly simple. You take the value of all the publicly traded companies on U.S. stock markets and divide that number by the U.S. annual gross domestic product (GDP) — the value of all goods and





services produced in the U.S. in a year. If the number is higher than one (U.S. stocks, in aggregate, are worth more than U.S. annual GDP), stocks can be considered expensive. If it's lower, they can be considered cheap (to the extent they are over or below that 1:1 ratio). So, let's look where the Buffet Indicator stands today:



Source: [Advisor Perspectives](#)

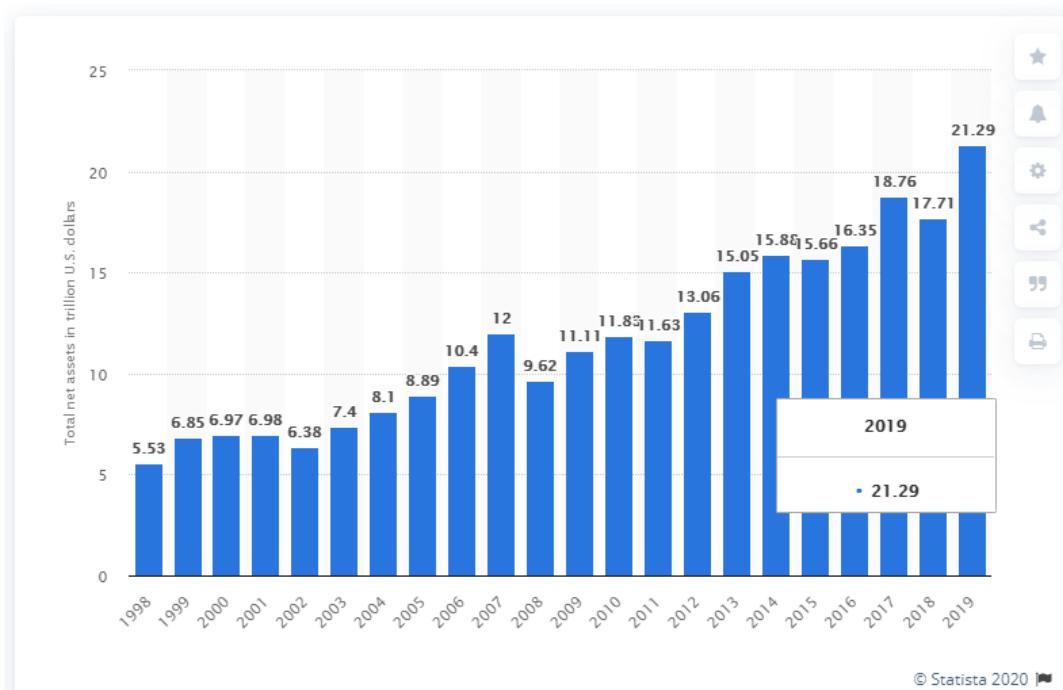
Since the relevant data started to be measured in the early 1950s, stocks have never been as expensive as they are right now. Put another way, according to the equation that [Buffett has said](#) provides "probably the best single measure of where valuations stand at any given moment," there hasn't been a worse time to invest in the U.S. stock market in 70 years.

Compounding the problem is that these pensions, endowments, and sovereign funds must invest right alongside everyone else in the U.S. stock markets. Competition for a limited pool of investment options is fierce. Mutual funds alone, in total, represent \$21T worth of such competition, and most of them are only allowed to invest in publicly traded U.S. stocks:





U.S. Mutual Fund Total Assets: 1998 to 2019 (\$T)



Source: [Statista](#)

Worse still, there are far fewer publicly traded stocks than there used to be. The [Wilshire 5000](#) Total Market Index — the broadest U.S. stock index — encompasses all publicly traded stocks on the three major U.S. stock exchanges: the American Stock Exchange (AMEX), the NASDAQ, and the New York Stock Exchange (NYSE). In 1998, it was comprised of [7,562](#) stocks. As of September 30, 2020, it is comprised of just [3,445](#) stocks. Incredibly, there are 54% less publicly traded companies in the U.S. stock market than there were 22 years ago.

2020 vs. 1998: Four Times the Money, Fewer Than Half the Stocks



Let's put this in context. Looking back to the mutual fund AUM chart, we see that in 1998, they managed \$5.5T. And they had over 7,562 options to invest in. Now? \$21.2T, and less than half the options.





4x the investable capital and 54% fewer places to put it. What's going to happen? As we've seen, the remaining stocks in U.S. markets have been bid up to at historically overpriced levels. Which begs the question: If it's such a historically bad time to invest in stocks, why not just invest in bonds?

ZERO-INTEREST-RATE POLICY (ZIRP): THE FIXED-INCOME-INVESTMENT KILLER

Understanding ZIRP is crucial to understanding not only the underlying macroeconomics of private equity, but why fixed-income investments are also an exceedingly unattractive investment right now.

Set by the Federal Reserve, the central bank of the U.S. government, the fed funds rate is the rate at which commercial banks may borrow from the U.S. government. Its current target range, as determined by the Federal Reserve, is 0%-0.25%. A rate range this low is referred to as zero interest rate policy (ZIRP). Essentially, it is the economic arm of the U.S. government saying "At any and all costs, we need to encourage business activity and investment because the economy is in dire shape. So, here's essentially free money to borrow, American business institutions — use it to create growth and jobs."

The fed rate also determines the loan rates for nearly all borrowed money in the U.S. — mortgages, prevailing credit card rates, and most importantly for our discussion here, the rate at which commercial banks lend money.

When the fed rate is at or near zero, high-quality bonds and other fixed-rate investments (those that return a guaranteed [unless they default] annual rate of interest) are unattractive to investors because they return so little. As of November 12, 2020, the average AAA-rated (the safest, highest-rated) corporate bond returned 2.36%. A five-year U.S. government bond (aka a Treasury bill, or T-bill) returned 0.41%. At a current inflation rate of 1.2% as of October 2020, investors earn a real net return of just 1.16% annually on AAA bonds and actually *lose* 0.79% of their investment's purchasing power investing in a five-year T-bill.

A key point is that this current Federal Reserve ZIRP backdrop is not a short-term situation; it has committed to keeping the fed rate at 0% through at least 2023. Fed Chair Jerome Powell has even gone so far as to say that the economy itself — such as we understood it to exist prior to the COVID-19 pandemic — may no longer exist. This unprecedented degree of Fed jawboning (describing the macroeconomy in illustrative terms without accompanying policy action) sets the stage for extreme and prolonged accommodative policy: in short, expect ZIRP to remain for many years to come.

Interest rates this low make fixed-income investments highly unattractive because they return nearly nothing. So, when the stock market is at a 70-year-high valuation and bonds offer next to no ROI, for large institutional investors, private equity funds are one of the very few other viable options. The net result was captured by the Preqin forecast above. Enormous amounts of capital will be flowing into private equity.

The flipside to ZIRP — that it costs almost nothing to borrow money, especially if you're a large and successful company — means that PE also needs to worry about competing with the largest U.S. corporate interests for potential acquisition targets.





Even before pandemic-spurred ZIRP, during the period from 2010-2019, the fed funds rate had been lower, for longer, than it ever had before. Predictably, even the stalwarts of the S&P 500 — the largest and most successful public companies U.S. — responded by going on a borrowing binge, [adding \\$2.5T in debt](#) to their balance sheets:

Blue Chip Debt Junkies			
	2010 Net Debt (bil)	2019 Net Debt (bil)	Increase Net Debt-to-Revenue
AbbVie	\$0.0	\$26.8	~
Eli Lilly	\$0.2	\$13.5	70.1 X
FedEx	\$0.1	\$16.8	67
Becton, Dickinson	\$0.5	\$19.2	17.1
3M	\$1.0	\$18.0	14.4
Occidental Petroleum	\$2.5	\$36.4	14.1
Exxon Mobil	\$6.6	\$49.7	10.1
Freeport-McMoRan	\$1.0	\$8.0	10
Yum Brands	\$2.3	\$9.9	8.9
Church & Dwight	\$0.2	\$2.1	8.2
Boeing	\$1.9	\$17.8	7.9
LyondellBasell Industries	\$1.9	\$12.4	7.9
Parker-Hannifin	\$1.0	\$8.8	6.6
O'Reilly Auto Parts	\$0.3	\$3.8	6.1
McKesson	\$0.8	\$9.9	5.7
Conagra Brands	\$2.6	\$10.4	4.6
McDonald's	\$9.1	\$33.1	4.1
IBM	\$16.9	\$54.1	4.1
Halliburton	\$1.8	\$8.2	3.7
DISH Network	\$3.6	\$11.4	3.2
Wynn Resorts	\$2.0	\$8.2	2.6
Coca-Cola	\$12.1	\$33.0	2.6
Campbell Soup	\$2.8	\$6.9	2.3
Altria	\$9.8	\$25.9	2.2
AT&T	\$64.5	\$151.0	1.6

Source: Factset, Senteo, CreditSights

Source: [Forbes](#)

All of that during a period when debt was *more* expensive to carry than it is now. After a year that offered actual ZIRP since March, as of early November 2020, so-called investment-grade debt — the kind issued by S&P 500 member companies — had soared by *another \$1.8 trillion in 10 months*.

When nearly interest-free debt is available to giant companies, they'll borrow furiously and figure out how to use the borrowed money later. One primary use? Acquisitions. Public companies, more than ever, are actively competing against PE firms for potential buyout targets.

But ZIRP is also extremely positive for PE firms who engaged in leveraged buyouts: How aggressive can you be when your cost to borrow money for acquisition is practically 0%?

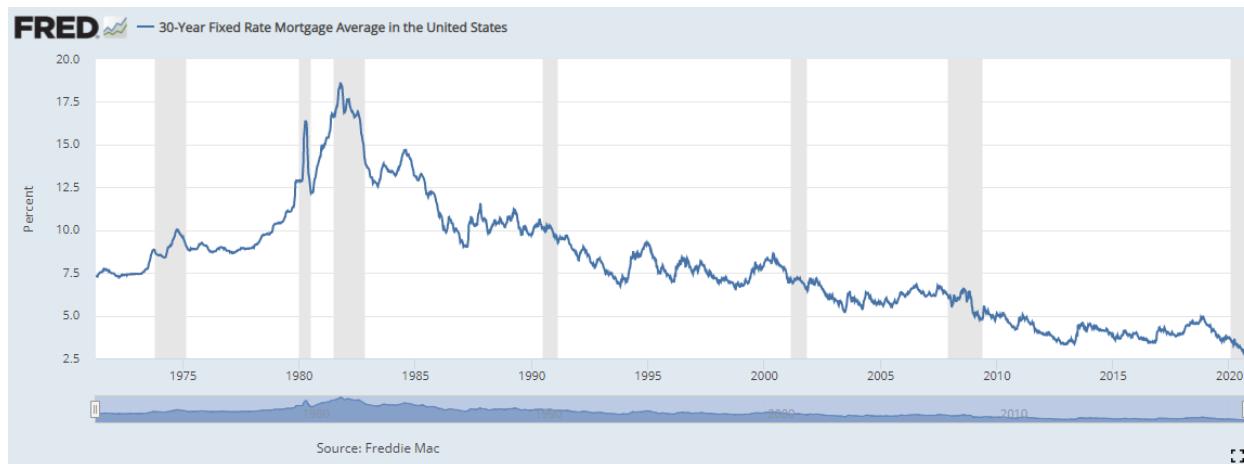




MARKET OPPORTUNITY IS LARGELY DEFINED BY COST TO BORROW

If you seek to borrow money for an investment, the most basic question to ask is “What is the likelihood I’m going to earn a greater return on investment (ROI) than I will pay in interest on the borrowed funds?”

For example, there was a brief window in the 1980s when you were going to pay 18% annual interest on a fixed mortgage:



This meant that from a sheerly financial perspective and assuming you carried your loan for 30 years, you had to be extraordinarily bullish for this transaction to make sense. You’d have to believe your newly purchased house was going to be worth 19% or more, every year, year after year, to give you more equity than you were losing in interest cost.

We now find ourselves at the opposite extreme of the home mortgage rate pendulum. Average 30-year-fixed rates hover around 3%. The underlying macroeconomics of homebuying, which once made homebuying prohibitively expensive, are now historically compelling for buyers.

At 18% interest making typical monthly payments, your home’s market value price would have had to *double* from your purchase price in *just over four years* to keep up with the accruing interest on your loan. At 3%? If its price doubles *in less than 25 years* (conservatively considering the principal you will have paid down by then — the decided majority — and ignoring the mortgage interest tax benefit), your home will be worth more than it cost you in loan interest to buy it.

This is a just one example of how the difference between a great investment and a terrible investment can be almost entirely determined by how much it costs to borrow the money required to acquire it.

In similar fashion, when the cost of borrowed capital from banks to highly qualified, perceived-low-risk professional investment borrowers (PE firms are at or near the top of this list) is near zero, [it pays for them to borrow very aggressively](#), given nearly any ROI at all will result in a profit on funds borrowed at close to 0% interest.





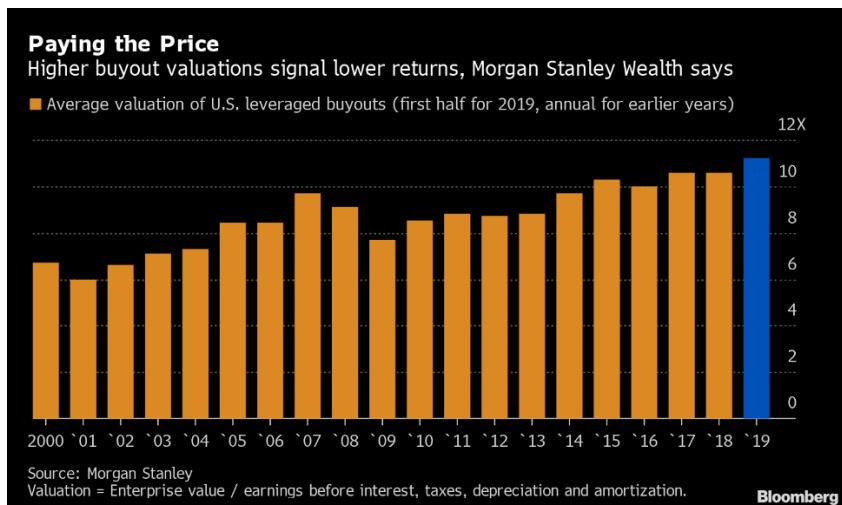
WELCOME TO RARE AIR: PRIVATE EQUITY

In an environment when fixed-income investments pay too little to be considered and the public stock market is both wildly expensive and exceedingly crowded, private equity offers the largest, most elite investors the next best option:

- **Much less competition for a fixed pool of assets** – Due to sky-high minimum investments — think \$25M — private equity funds are simply out of the reach of the vast majority of individual investors. So that \$21.29T in mutual fund money competing for publicly traded stocks and bonds? Not an issue, because 1) mutual funds can hold a maximum of 15% of their assets in illiquid investments (including private companies) and 2) more importantly, only several hundred of the roughly 8,000 U.S.-based mutual funds held any shares in private companies, and only a fraction of those had such investments amounting to more than 5% of total assets.
- **Advance access to the investments that become stock market darlings later** – Along similar lines, private equity allows investors to own part of a company before its initial public offering, when it becomes a publicly traded stock anyone can buy. Imagine owning Amazon, Google, or Facebook before it ever traded as a public stock. Then, once it does become a public stock, all that mutual fund money can suddenly flow into it, driving up the price. But if you invested as a private equity investor, you owned it before they ever could have.
- **Again, it's anything other than fixed-income or stocks** – With the two far-and-away-most-popular investment sectors massively unappealing for the aforementioned reasons, private equity offers something (anything!) that isn't handicapped by serious, basic investment thesis problems.

EVER-EXPANDING VALUATIONS

The only logical result of these confluent forces is that PE funds end up paying more for more deals more often:



Source: [Bloomberg](#)





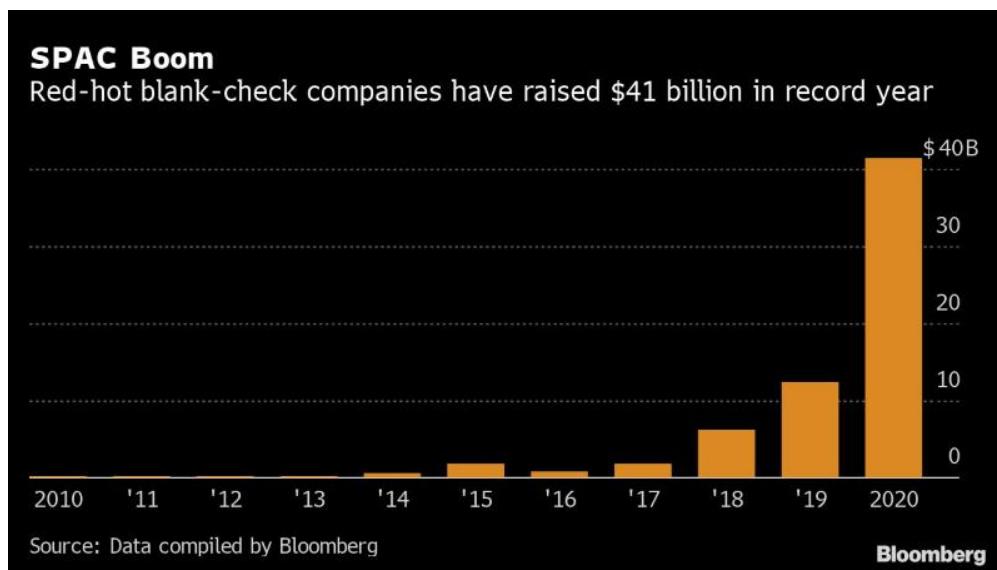
After retrenching following the 2008 financial crisis, PE deal valuations have headed steadily higher. And given the record-high-and-rising amount of PE capital sitting on the sidelines waiting to be spent on acquisitions, there's no reason to think this trend will slow down anytime soon.

SPAC ATTACK

There's a reason that 2020 has been called "[The Year of the SPAC](#)" in the private equity world. Also known as blank-check companies, SPACs (special purpose acquisition companies) are unallocated pools of capital that then obtain a publicly traded stock market listing — essentially an IPO without a company — with the intent of acquiring a company for that listing.

The IPO process can be long, arduous, expensive, and uncertain. SPACs, typically formed by experienced and well-capitalized investors, give private companies a way around all of that. They do the many months of heavy lifting and dirty work usually required of a company getting ready to go public ahead of time.

This model has been around for years, but it has taken off in 2020:



Source: [Bloomberg](#)

So far this year, more than 10x as much money has been allocated to SPACs as in the 10 previous years **combined**. While the \$41B raised this year is dwarfed by the \$1.45T in PE fund dry powder, the rate of SPAC growth is remarkable, and it offers a new avenue for even more investor funds to seek out private companies.

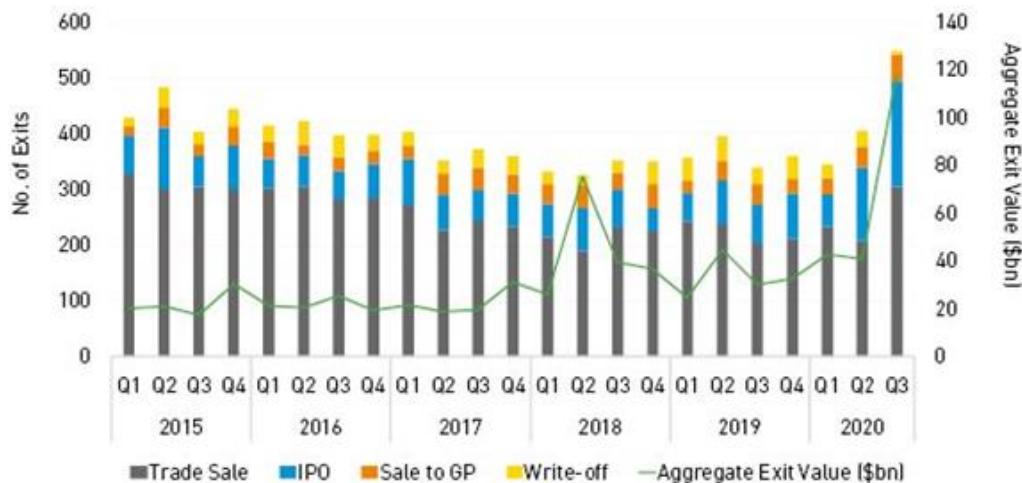




THE VENTURE CAPITAL CANARY IN THE COAL MINE

While venture capital and private equity are not synonymous, they are essentially two halves of the same continuum. Venture capital invests in smaller companies, early in their life cycles, that have the potential to become massive breakout successes. Private equity invests in larger, more mature companies. Yesterday's venture capital success stories are today's private equity prime targets.

Chart of the Week: Quarterly Venture Capital-Backed Exits by Type, Q1 2015 - Q3 2020



Source: [Preqin](#)

Sure enough, Q3 2020 saw an all-time record for total value of venture capital-backed exits (events that monetized the venture capitalists' investments in the portfolio companies). Competition for startups that have started to gain traction and market share is fierce.

THE BOTTOM LINE: NO BETTER TIME TO BE AN ACQUISITION TARGET

You have the powerful tailwind of ZIRP. A fixed-income market that offers almost no ROI. A stock market that is historically overvalued. Private equity funds already sitting on an all-time-record amount of available-to-invest capital and forecasts indicating this cash hoard is set to spike significantly further over the next five years. PE deal valuations continue to get richer with no end in sight. Venture capital exit values are skyrocketing. The SPAC market is red hot, representing an entire new sector of potential suitors for private companies.

In short? It's a nearly perfect storm of a seller's market, and private equity funds are looking — ever more urgently — for the next big thing. There has never been a time when it made more fiscal sense to make positioning your company as a dynamic, innovative market leader your highest priority.



About the author

Alex Trigaux has spent his adult life immersed in the financial markets. After an early career at \$1B venture capital fund Atlas Venture provided his boots-on-the-ground private equity experience, he has traded stocks and invested independently for 25 years. Alex has contributed to financial publications at industry leaders including Standard & Poor's Capital IQ and AllianceBernstein, and helped build linguistics-based financial fraud detection modules as a consultant for Boston-based AI startup Topos Labs. [\[Back to Top\]](#)

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