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The definition of private equity investing is very broad. This newsletter will focus on the buyout of publicly-traded companies by private equity funds, an area of private equity investing that is currently booming.

Private equity funds are pools of capital dedicated to buying companies, typically because the buyers think they can run the target company better than the current management or because the buyers want to leverage their balance sheets during the purchase and eventually resell the company for a higher price. In many cases, the latter approach may involve the eventual resale of a company in the same public market from which it initially was purchased.

After the burst of the Internet bubble in 2000 and the bear market that followed, public market investors favored companies with good balance sheets. These same companies are now the target of the private equity investors, but for different reasons. Where the public market investors favored such companies because they could withstand an economic downturn, raise their dividends or buy back their own stock, the private buyer sees a company that can be taken private using the company's own cash and borrowing ability.

The more traditional private equity investors focused on companies they thought were inefficiently managed, that could be improved with better management or the sale of subsidiaries that were not related to the primary business. The current buyout boom seems more focused on balance sheets and debt. This has been facilitated by our relatively low interest-rate environment and bond buyers' willingness to take on more than the usual risk. The interest rate differential (spread) on low-quality bonds vs. high-quality bonds has never been smaller. This relationship will probably revert to a more normal spread in time.



It is difficult to say how this buyout boom will end, but we know that it will. Higher interest rates or a more normal aversion to risk by bond buyers would slow it down. Moreover, the huge amounts of money that private equity funds have managed to raise by taking advantage of investors' current enthusiasm still needs to be put to work. The very pressure of having to put the money to work will reduce returns for these same funds. It is a case of too much cash chasing too few assets.

The marketers of private equity funds have the luxury of touting historic returns without having to show annual returns until the investments are liquidated. This, of course, is usually years down the road. This void makes it easy for them to raise money from investors.

Private equity investing has been around for many years and is an asset class just like stocks, bonds or real estate. What is new is its huge, and in our opinion overblown, popularity. When an asset class becomes too popular it is destined to underperform. It happened with the Internet stocks in 2000. It is happening in real estate now, and it will happen with private equity over the next five years. To those showering money on this asset class, caveat emptor.