Success Can be Scary! says McTevia to PrivateEquityCentral.net

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Boo Who?

It is Halloween and that means it is that time of the year again when the three C's come out. No, we are not talking about candy, costumes and creepiness. As Jay Tannon, a private equity lawyer from DLA Piper, says, Congress, credit and competition are far scarier for the asset class this year.

As anyone following private equity already knows, one of the biggest news stories of the year has been the proposal to change the tax code for private equity investors. Current tax laws have private equity firms paying capital gains taxes of 15% on their carried interest, which comprises the bulk of their earnings. Private equity firms view this as a long-term capital gain and as a result say it should be taxed as such. They pay a corporate tax rate of 35% on other income, like their management fees.

According to a number of analysts, Congress is highly unlikely to revisit this idea this year and it could be quite some time before the issue is brought before lawmakers again. As Tannon says, with 2008 being an election year the odds of politicians raising taxes are slim. Plus, he does not think President Bush will allow it to happen.

"Whenever somebody makes a lot of money, people get jealous," says James McTevia, a managing member of crisis management specialist firm McTevia and Associates. "That is one scary thing."

When it comes to credit, perhaps the scariest thing that can happen is the domino effect of a tightening market. The related effects include a lack of realizations due to there being less favorable pricing. As a result, firms will be forced to hold onto portfolio companies for longer than they had initially planned. The longer companies stay in the firm's portfolio, the more money firms will be forced to shell out in order to make the companies more attractive to buyers. The more money put into a portfolio company, the lower the returns.

Fewer realizations will translate into less capital being raised by firms when it comes time to close a new fund since limited partners will be less wowed by earnings. Although the specter of that happening is pretty darn scary, that may not be what is actually occurring. In fact, it may be the opposite.

"Despite what is happening in the credit markets right now, we are not hearing that investors are

slowing down their investment pace," says Doug Jarrett, a partner with placement agent BerchWood Partners. "I am not saying that will not happen, [but] the inverse is actually happening right now."

When it comes to the competition part of the three C's, that could mean competition for U.S. private equity from overseas as well as competition of another sort - the competition to find the right personnel. According to Ronald Norelli, founder and chairman of private equity support firm The Norelli Group, there is a serious shortage of top flight talent.

As the asset class continues to grow in popularity and more firms are created, the demand grows for employees, but the supply may not keep up. Norelli says this kind of vacuum will create a greater need for really good talent that knows how to market and how to create value.

"That is another scary thing," says Norelli. "Waking up one day and not having what you think you have in terms of a talent pool or a management pool [being] up to the challenges of [what] that particular business are going to be."

The way to avoid that problem, according to Norelli, is for private equity firms to be just as diligent in their hiring as they are in researching deals. He says firms need to put the proper processes in place to find good people. Although most firms will not admit to this being a problem or an issue, Norelli says it is a major concern moving forward.

"Not having the talent will get a trick played on them rather than a treat," says Norelli.

Although there are some seriously scary potentialities out there for private equity right now and in the coming months, investors should not let the ghouls and ghosts of Halloween spook them too much. It really is not all gloom and doom right now. Many continue to express optimism at the resilience of the asset class.

"This is a very creative industry and it still defines the standard globally," says Elizabeth Cobey, a shareholder with the law firm of Greenberg Traurig. "If there is a perceived return to be made on an opportunity, private equity sponsors do find a way to make it."