Private Equity's Pricey Rebound
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Private-equity deal activity started out with a whimper this year. Investors and bankers say that they expect it to end, if not with a roar, then at least a growl. But that doesn't bode well for future returns.

Through Sept. 8, private-equity firms backed just 407 deals, the lowest level by number for the period in five years, according to data provider Dealogic Ltd. However, the dollar value of those deals hit $91 billion over the same period, an increase from $86.8 billion for the year-earlier period.

Industry participants expect there will be a burst of activity in the remainder of the year, driven partly by favorable deal conditions. Not only is there a tremendous amount of private-equity capital waiting to be deployed, the financing market is receptive to the point that it allows for refinancing as well as repricing of debt.

The volume of leveraged loans, or borrowings private equity used in transactions, amounted to $38 billion this year through Aug. 31, compared with the $35.5 billion issued for the year-earlier period, according to Leveraged Commentary & Data, an offering of S&P Global Market Intelligence.

"In the first quarter, the market was very distressed, with the Dow down 10%," said David Brackett, a managing partner with lender Antares Capital. "Think about the ripple effect in the economy. We are now seeing in the third quarter and fourth quarter the economy is beginning to strengthen.

Mr. Brackett added he expects to see more sellers bring companies to market in the hopes of securing good pricing.

But some caution that those buying into this environment run a higher risk of overpaying, making it more difficult to produce strong returns. Much of private equity's value lies not in making money during good times, but in generating sustainable returns in bad times. Some investors are cautioning against what they call "plain vanilla" transactions, in which investors plan to rely on continued multiple expansion to generate their returns.

Henry McVey, who heads global macro and asset allocation for KKR & Co. said in a recent KKR report that global, multiasset class investors should focus on expanding exposures to complex investment situations while reducing exposures when it appears investors may be overpaying for earnings visibility or simplicity—or both.

When the market eventually does turn, these companies and their backers face bigger challenges, particularly given that many already were left with fairly lean operations after the prior economic downturn.

"There are few cost savings to be done," said an investor with one of the big buyout firms, adding that an unfortunate combination of high valuation and slow growth probably will likely point to rescue financing or distressed opportunities "two years down the line."