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Understanding the new world order of private equity

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The Federal Reserve System's Private Equity Merchant Banking Knowledge Center, formed at the Chicago Fed in 2000 after the passage of the Gramm–Leach–Bliley Act, sponsors an annual conference on new industry developments. This article summarizes the tenth annual conference, The New World Order of Private Equity, held on July 21–22, 2010.

By a number of measures, the state of private equity has improved since the worst of the financial crisis, but many features of the asset class have been altered.

To kick off the conference,[1] Carl Tannenbaum, Federal Reserve Bank of Chicago, reflected briefly on the decade since the passage of the Gramm–Leach–Bliley Act. These years saw extensive financial innovation, along with the removal of regulatory barriers that traditionally separated the activities of commercial and investment banks. The financial crisis prompted a reevaluation of many views that had been widely held, culminating in President Obama signing the Dodd–Frank Wall Street Reform and Consumer Protection Act on July 21, 2010 (by coincidence, the first day of the conference).

In another wide-ranging presentation, Glenn Hutchins, Silver Lake, offered a sobering assessment of the long-term challenges facing the U.S. economy. He emphasized how massive deleveraging by financial institutions, businesses, and consumers could severely reduce future economic growth. He also warned that recent fiscal and monetary stimulus programs could lead to future problems, such as unsupportable levels of public debt or high inflation. U.S. consumers, who represent approximately 17.5% of global gross domestic product (GDP), may no longer be relied upon to drive economic growth. Hutchins also stressed the potential loss of competitiveness over the long term for the U.S. and other developed economies relative to China and other emerging countries. Hutchins cited a number of negative indicators in the U.S., such as rising health care and energy costs, the trade deficit, governmental budget deficits, loss of leadership in technological innovation, lagging educational systems, and political polarization.

State of the industry

A panel led by Mark O'Hare, Preqin Ltd., explored the evolving role of private equity (PE) in the economy and in investor portfolios. It featured Paul Carbone, Baird Private Equity; John Crocker, Atlantic-Pacific Capital; William Franklin, Conversus Asset Management; Greg Uebele, The Boeing Company; and Wilson Warren, Lexington Partners. Based on extensive data presented by O'Hare, PE has clearly improved since the severe downturn it experienced in late 2008 and early 2009. Net cash flows to limited partner (LP) investors (see note 1) fell sharply during that time period. Valuations have recently recovered after large declines. The impact was most severe in the largest ("mega") leveraged buyout (LBO) funds,[2] but these have also rebounded substantially. Surprisingly, even the worst vintage of LBO funds—2006—has largely recovered its value, reflecting favorably on the PE business model.

Fundraising is still very challenging, but LPs, by a large margin, still plan to maintain or increase their allocation to PE, especially in smaller funds and specialty areas. Deal flow has clearly recovered, particularly in North America and Asia, covering a wide range of industries. In the secondary market,[3] strong motivation to sell on the part of LPs needing liquidity has been offset by the large price discounts sellers have recently faced. Finally, O'Hare cited a number of studies indicating the favorable effects of PE on the broader economy. These include creating jobs, improving the performance of portfolio companies, providing superior returns to pension funds and not-for-profits, spurring innovation, and seeding economic recoveries.

The panelists, representing both general partner (GP) and LP perspectives (see note 1), provided additional context for these industry data. They noted how the quality of valuations has improved in recent quarters, coinciding with the application of fair value accounting rules.[4] In addition, new legal and regulatory developments (discussed in detail later) may significantly increase secondary market sales, since banks will be required to divest some of their PE investments. At the same time, banks are increasingly being targeted for investment because of the current challenged state of the banking industry and its need for new capital.

Steven Pinsky, Sutton Advisory Group, led a panel of investment professionals that discussed PE trends in the recent economic cycle. The panel comprised Warren Feder, Carl Marks Capital Advisory Group; Thomas Janes, Kerry Capital Advisors; Joseph Linnen, The Jordan Company; and James Marra, Blue Point Capital Partners. The panelists identified recent trends in PE activity, mergers and acquisitions volume, deal flow, fundraising, and other factors that reinforced the conclusions of O'Hare's panel.

Meredith Coffey, LSTA, surveyed recent developments and future prospects in the leveraged loan market.[5] In the 12 months prior to the conference, there was a considerable recovery in this market, followed by a small retrenchment due to European sovereign debt problems. A large volume of leveraged loans, which Coffey referred to as the "refinancing cliff," is due to mature over the next few years. Strong issuance of high-yield bonds during 2009 and the first four months of 2010 has supported the refinancing process, but high-yield issuance dropped sharply in May and June. Purchases of leveraged loans by issuers of collateralized loan obligations (CLOs)[6] will need to play an important role in reducing the size of the refinancing cliff. However, Coffey indicated that recent legislation, specifically the Dodd–Frank Act's risk retention requirements for certain securitizations and the Foreign Account Tax Compliance Act, threatens the revival of the CLO market (and thus the future liquidity of the leveraged loan market).

> The new financial reform legislation will significantly affect banks' involvement in private equity; however, many of the specifics remain unclear.

LP perspectives

John Kim, Court Square Capital Partners, led a panel of LP investors, made up of Stephen Can, Credit Suisse; David Fann, PCG Asset Management; John Rompon, McNally Capital; and Greg Turk, Teachers' Retirement System of the State of Illinois. The panel was subtitled "passive no more," implying increased assertiveness on the part of LPs. However, panelists indicated that most LPs have had limited success in "shifting the paradigm" of GP/LP relations—the top GP firms are still able to raise money on their own terms. Nevertheless, LPs with larger amounts of capital to offer are able to obtain marginally better terms in the current environment. Investment opportunities over the next 18 months that the LPs were most interested in included mezzanine[7] and other fixed-income securities, "rescue financing" for deleveraging companies, and "dislocated and distressed seller" transactions—all relatively nontraditional targets for PE by historical standards.

Investing in the financial sector

Mark Gormley, Lee Equity Partners, assessed the opportunities and risks of investing in the financial sector. Historically, a significant amount of private capital has been invested in financial institutions in difficult times, such as when banking problems arose in the late 1980s and early 1990s and during the most recent banking crisis. Gormley judged that, from a policy perspective, the regulatory response to the most recent crisis has seemed to be appropriate—regulators have proactively and effectively managed the impact of bank failures. However, he also said that in some cases regulators may have been too patient with distressed banks, allowing them to persist with minimal or negative equity. Letting banks remain impaired reduces new loan origination; this in turn lowers new job creation and slows the pace of economic recovery. Gormley said that, with fund managers having allocated more than $20 billion of funds to recapitalize banks, private capital can be an important part of the solution. Private capital investors assist firms by 1) working with seasoned management teams, acting where strategic, more short-term-oriented investors often cannot, and 2) focusing on long-term value creation. Therefore, private capital offers a needed, willing, and valuable resource in the recovery of the banking sector.

The global venture capital model

Randy Mitchell, U.S. Department of Commerce, moderated a discussion on global venture capital (VC), with panelists Robert Ackerman, Allegis Capital; Susan Boedy, Knightsbridge Advisers; Victor Hwang, T2 Venture Capital; Matthew McCall, New World Ventures; and John Taylor, National Venture Capital Association. While VC funds represent only 0.2% of U.S. GDP, revenues from former VC-backed firms correspond to 22% of GDP. U.S. VC assets under management are down about 35% from their recent peak, but Taylor attributed this to a "healthy shakeout" from some of the excesses of the tech bubble ten years ago. Investment in U.S.-domiciled venture funds continues at a respectable pace. Most of this money has been invested in U.S. targets, but there have also been spurts of investment activity in Chinese and Indian targets. With few new initial public offerings (IPOs) since 2007, strategic acquisitions have become increasingly important exit vehicles for venture investments, with many good companies "waiting in the wings" to be acquired.

Panelists stressed how VC is a unique business dependent on an entrepreneurial, "mentoring" culture and an "ecological" network of small firms in proximity to each other and to sources of capital. This start-up ecosystem depends upon a delicate balance between risk and reward. Currently in the U.S., risk appears to be increasing and reward decreasing. The opposite appears to be true for some other countries that compete with the U.S. The entrepreneurial activity in China and India reflects these dynamics.

The environment for VC varies greatly across nations and can be adversely affected by regulation and other public policies. However, policy can also have a positive catalytic effect in addressing market failures in emerging regions; e.g., global venture markets are starting to flourish largely because of the role of foreign government investment. This sovereign investment activity can be seen stretching far beyond just the China and India markets. Overall, the panel was optimistic about investing in VC at this time, and there was even some suggestion that a great new wave of innovation might be imminent.

Risk-management and compensation issues

A panel on risk management was moderated by Timothy Kelly, Adams Street Partners. The panelists were Eric Eubank, Pamlico Capital; Edward Hortick, VCFA Group; Christopher Laursen, NERA Economic Consulting; and Pierre-Yves Mathonet, European Investment Fund. These panelists emphasized the many dimensions of successful risk management in PE. Risk-management processes must cover the entire life cycle of PE investment (origination, analysis, due diligence, approval, closing, documentation, monitoring, and sale). They must also address each level of activity—i.e., portfolio investments, funds, and funds of funds. While quantitative methods (such as stress testing) are important, the human element (in the form of leadership, culture, attitudes, and so forth) is equally crucial. The panel attributed the recurrence over time of large, unexpected losses at financial firms to a number of factors. These included limitations of models, the human tendency to forget lessons over time, and pressures to grow businesses by lowering risk-management standards.

Whether compensation practices at financial firms may have contributed to excessive risk-taking has been a major recent concern for policymakers. Steven Kaplan, University of Chicago, provided a detailed look at compensation in PE. He concluded that compensation arrangements have been very lucrative for successful PE investors. He characterized these practices as useful tools to generally align the interests of GPs with those of LPs and predicted that recent principles formulated by the LP community would create pressures for further alignment. Kaplan also predicted that proposed changes to U.S. tax laws increasing the taxes on PE firms would modestly reduce the attractiveness of PE (especially VC), lead to attempts to circumvent the changes, and create more conflict between GPs and LPs.

Private equity and financial reform

Subject to certain exceptions and a transition period, the so-called Volcker rule portion of the Dodd–Frank Act prohibits any "banking entity" from engaging in proprietary trading or from sponsoring or investing in a hedge fund or PE fund. It also requires systemically important nonbank financial companies to carry additional capital and comply with certain other quantitative limits on such activities, although it does not expressly prohibit them. The Volcker rule will become effective no later than two years after enactment, at which point a two-year transition period begins, with the possibility of additional extensions thereafter.

William Mark, Federal Reserve Bank of Chicago, led an interactive discussion with the audience about the impact and implementation of the Dodd–Frank Act. Although banks make up a relatively small portion of the PE asset class (estimated by some at around 9%), participants expressed concern about the potential reduction in capital available to the U.S. economy as a whole. Among the unresolved questions concerning the law are whether VC is excluded from the investment restrictions because of its purported contributions to economic growth, whether banks' direct balance-sheet investments (as opposed to sponsored or third-party funds) are also exempt, and exactly how the "grace period" for divestitures (including the various extensions) is to be calculated.

Mark also interviewed Richard Smith, One Equity Partners, about how fund managers are able to maintain strategic focus in a rapidly changing environment shaped by new regulations and tax rules, among other factors. Smith emphasized

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that his firm, guided by a distinctive but resilient business model, provides value to its parent, JPMorgan Chase, in terms of both return and "intellectual capital." In addition, since his firm uses only the bank's capital (and none from a third party), he argued that One Equity Partners does not generate systemic risk.

Conclusion

To close the conference, Tannenbaum provided a regulatory perspective on current financial conditions. The economy is likely in recovery. Credit market conditions have improved, but new securitization issuance remains well below pre-crisis levels. Bank lending is slowly recovering, but real estate credit remains a focus of attention for many firms. The crisis has reinforced the continuing relevance of the business cycle and the importance of understanding the so-called shadow banking system.[8] It has also shown that liquidity can disappear abruptly, even for otherwise solvent institutions, and that risk-management discipline cannot be ignored with impunity. Watchwords for the new world order of PE might be "recapitalize, revitalize, and reprivatize."

[1] For more information about the conference, see www.chicagofed.org/webpages/events/2010/private_equity_conference.cfm. Private equity funds are pools of capital invested by a private equity partnership, typically involving the purchase of majority stakes in companies (not listed on a public stock exchange) and/or entire business units to restructure their capital, management, and organization. The standard vehicle for investment in private equity funds is the limited partnership. The manager of the fund, the partnership's general partner, makes, monitors, and ultimately monetizes investments for a return on behalf of the investors (the limited partners). Limited partners include pension funds, insurance companies, asset management firms, and fund-of-fund investors.

[2] Leveraged buyouts involve the acquisition of a company using a significant level of borrowing (through bonds or loans) to meet the cost of acquisition. Usually, the assets of the company being acquired are used as collateral for the loans.

[3] A secondary market is a market where an investor purchases an asset from another investor rather than from the original issuer.

[4] U.S. accounting rules that expand and clarify the use of fair value (or "mark-to-market") accounting went into effect at year-end 2008 for most firms. Implementation of these rules was controversial during the worst of the financial crisis, when some market values were severely depressed and may not have represented true economic values.

[5] A leveraged loan is a bank loan that is rated below investment grade (BB+ and lower by Standard & Poor's or Fitch, and Baa1 and lower by Moody's) to firms with a sizable debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) ratio, or it is one that trades at wide spreads over Libor, or London interbank offered rate (e.g., more than 150 basis points).

[6] CLOs are structured credit securities backed by whole commercial loans, revolving credit facilities, or letters of credit, where interests in the securities are divided into tranches with differing repayment and interest-earning streams.

[7] Mezzanine funds target debt instruments that provide the layer of financing that has intermediate priority (seniority) in the capital structure of a company, demonstrating both debt and equity characteristics.

[8] The shadow banking system is a network of lenders, brokers, and opaque financing vehicles outside the traditional banking system that has grown substantially in recent years and has been much less regulated.