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Challenges for private equity—The shifting winds of risk

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The Federal Reserve System's Private Equity and 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 2006 conference, "The Shifting Winds of Private Equity Risk," held July 19–20.

Private equity refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market.

In his opening remarks at this year's private equity conference, Michael H. Moskow, president and CEO, Federal Reserve Bank of Chicago, reviewed some recent developments in the industry and related risks.[1] In 2005, the private equity industry continued to grow, mature, and become more mainstream. This growth reflects both cyclical phenomena, such as ample liquidity in the financial markets, and structural changes. One structural change is a blurring of the lines between private and public markets, as happened when a prominent private equity firm, Kohlberg Kravis Roberts & Co., raised funds through a large public offering earlier in 2006.

Moskow also updated three themes he had articulated at the previous year's conference: corporate governance, globalization, and what he called the "changing of the guard" in the private equity industry. Corporate governance is becoming more critical. As pension funds and other institutional investors move into private equity, a broader class of individuals is exposed to the risks of the industry.

In particular, the reputational risks have grown with some recent unfavorable publicity. For example, one recent article accused some private equity firms of taking exorbitant advisory fees from newly acquired firms and burdening them with heavy debt loads, as well as engaging in other unsound business practices, such as inadequate disclosure, questionable accounting, and influence peddling.[2] Moskow suggested that one way for the industry to counter these perceptions would be to voluntarily implement certain governance requirements of the Sarbanes–Oxley Act of 2002, such as those relating to codes of ethics, audit committee independence, and financial statement accountability.

Regarding globalization, U.S. private equity firms are making a wave of acquisitions abroad, and Wall Street firms are competing furiously for foreign investment opportunities. These trends increase political, legal, and reputational risks.

Finally, Moskow revisited the "changing of the guard": the retirement of some seasoned industry veterans and the movement of others to new firms. This trend creates significant challenges for management succession. At the same time, however, many highly successful managers of public companies are migrating to private equity.

The "new normal"

Keynote speaker Roger B. McNamee, Elevation Partners, argued that the economy in the current decade has entered into a totally new era, which he dubbed the "new normal."

According to McNamee, the U.S. economic environment has become less conducive to economic growth, executive compensation still shows signs of the excesses of the 1990s, and Sarbanes–Oxley has produced major unintended consequences, including the imposition of large costs on public companies. In addition, changes in accounting standards have actually reduced standardization and comparability, while penalizing smaller, growth-oriented companies by requiring the expensing of stock options. Finally, the regulation of financial markets has not appropriately addressed the unique features of hedge funds.

Private equity firms could reduce reputational risks by setting the appropriate “tone at the top” and developing enterprise-wide compliance functions.

In light of these trends, McNamee encouraged the private equity industry to move beyond risk-averse and “zero-sum” thinking and embrace long-term, transformative, and value-creating investment opportunities.[3]

The state of private equity

Avy H. Stein, Willis Stein & Partners, surveyed the current state of the private equity industry. Investors (such as pension funds, insurance companies, not-for-profit organizations, and high net worth individuals) are increasingly turning to the alternative investment classes, including private equity. Primary reasons for this shift are the superior comparative returns in private equity and the poor performance of the stock market during the current decade. As a result, private equity fundraising has hit record high levels, with foreign investors doubling their share of private equity investing since the late 1990s. “Mega funds” have received a growing share of new capital going into private equity—over $120 billion in the past 24 months. As these funds put capital to work, private equity transactions have become larger than ever—eight of the ten largest deals in history were completed or announced in 2005 and 2006. These “mega deals” are also being structured with higher purchase multiples and significantly higher leverage than in the past decade.

Potential sources of concern for the industry include competition from other vehicles such as hedge funds, the ability to sustain current strong returns, potential pressure from higher credit spreads and reduced credit availability, and conflicts of interest between investors and portfolio companies. Nevertheless, Stein stressed that private equity firms can generate superior value creation by adopting longer time horizons than public companies, attracting first-class management, creating operating efficiencies, and strengthening the balance sheet. He made the case for middle market private equity investing, in which transactions are being priced approximately 20% lower on a multiple basis than the mega deals and in which there are considerably more targets for investors.

The private equity industry has been particularly affected in recent years by the encroachment of hedge funds, attracted to private equity by strong returns, especially over the past three years. Shorter-term strategies of hedge fund managers, combined with their shorter-term fee structures, potentially clash with the typically illiquid nature of private equity funds. Hedge funds have both competed with private equity funds and played complementary roles, as when hedge funds serve as sources of debt capital, potential acquirers of portfolio company assets, or partners in various transactions.

An example of one corporation’s strategy was provided by Elizabeth M. Allison, The Boeing Company. Alternative assets for Boeing include private equity; hedge funds; real estate; and real assets, such as commodities, oil and gas, timber, farmland, and infrastructure. Advantages of alternative assets include the potential to outperform traditional asset classes, low correlation with these asset classes, portfolio diversification, leverage, and steady growth in the supply of skilled asset managers.

The middle market represents a broad spectrum of industries, ranging from high technology to manufacturing, and has traditionally been defined as companies with revenues of $10 million to $1 billion. Middle market target firms play a key role in the private equity industry. The emergence of the mega funds has brought concerns that middle market companies will be neglected in their quest for investors. In actuality, robust fundraising has brought an influx of capital chasing deals of all sizes. A panel moderated by Sajan K. Thomas, Thomas Capital Group, explored the challenges of the current middle market environment. The panelists (representing both general partner and limited partner perspectives) were C. Andrew Brickman, Baird Capital Partners; Du H. Chai, Northwestern University; Peter Keehn, Allstate Investments LLC; and Timothy J. MacKenzie, Merit Capital Partners.

Panelists noted that the rise of mega funds and mega deals has blurred the traditional size boundaries of the middle market and shifted them upward. In addition, middle market firms face the same complex legal and governance issues as their larger counterparts, but usually with less infrastructure and fewer resources at hand. For the middle market private equity investor, ongoing hurdles include the overvaluation of portfolio companies, high expectations by limited partners for income and growth versus current prospects, competition in a global economy, and compliance with Sarbanes–Oxley regulations.

Globalization in the world economy is also affecting private equity. Neil A. Brown, Citigroup Alternative Investments, moderated a panel that focused primarily on developments in Asia. The panelists were John Crocker, Citigroup; Andrew W. Rice, Jordan Industries Inc.; and Suresh Shanmugham, SVB Financial Group. Crocker explained that globalization has been furthered by compelling macroeconomic trends in the Chinese and Indian markets, as well as increasing competition in the U.S. and Europe, which may lead to lower return expectations in these latter regions. Other attractive features of emerging markets are improved legal and regulatory frameworks and corporate governance, seasoned local fund managers who are more actively engaged with portfolio companies, and greater ease of exit. Crocker argued that North Asian countries (especially Korea, Japan, and China) offer the greatest buyout opportunities.

Jordan Industries has been navigating the challenging investing environment in the huge Chinese market since 1995. Chinese companies have been looking to foreign partners not only for capital but also for assistance with controls and procedures to help them become world-class suppliers. Nevertheless, Rice noted that most U.S. investment in China will be used to serve the Chinese market. While there is a growing awareness of the positive role of foreign investors in China, there is also a media-driven backlash against foreign ownership.

India, according to Shanmugham, offers the attractions of a large and fast-growing domestic market, a large English-speaking population, the highest number of engineers in the world, and a relatively young population. Challenges of doing business there include inadequate infrastructure, the rising cost of talent, and the slow pace of doing business in a relationship-driven society. Shanmugham encouraged potential investors to start early and take a long-term perspective, think beyond information technology to other products and services, and gain an understanding of local market nuances.

Leverage and liquidity

Several sessions of the conference explored leverage and liquidity issues related to private equity. One panel focused on the impact of leverage on private equity and other debt issues. Moderated by David Gezon, Midwest Mezzanine Funds, the panel featured Douglas P. Sutton, BMO Mezzanine Fund, and Ryan Zanin, Deutsche Bank. Competition among lenders to provide funds to the leveraged finance industry has increased leverage ratios, driven down borrowing costs, and loosened terms. The growing role of nontraditional lenders, such as hedge funds, has ratcheted up competition. Panelists noted that hedge funds, with their shorter-term, more transactional perspective, are bringing greater pricing discipline into the process, but they may also change the dynamics of workouts in the event of a downturn.

Banking organizations play diverse roles in private equity. As investors, banks benefit not only from high returns but also from synergies, such as being able to redistribute private equity investments to their asset management arms. As lenders, banks are getting better at managing the risks of lending to highly leveraged portfolio companies, which now make up a major share of the middle market. However, many banks are exiting the private equity business, both because its volatile returns are ill-suited to the steady consolidated returns favored by bank shareholders and because business synergies can also generate conflicts of interest.

Private equity limited partner interests generally have 14-year lives. Liquidity from the "secondary market" has historically been provided at a material discount to reported value, thereby forcing the seller to book a loss. Today, secondary sales are transacted at discount, par, and premium bids to reported value. This behavior suggests greater efficiency in the market, yielding a fairer pricing environment and increased transaction volumes.

The secondary market panel, moderated by John K. Kim, Court Square Capital Partners, featured Stephen H. Can, Credit Suisse Strategic Partners, and Jerrold Newman, Willowridge Incorporated. From a relatively small annual U.S. volume of $5.6 billion in 2005, Can anticipated continued and consistent growth in this market for the next several years. Can argued that growth will come from a new type of seller—portfolio managers actively managing their private equity investments in new ways. For example, these managers are locking in gains (by selling limited partnership, or LP, interests in "winners"), decreasing administrative burden (by selling old and small LP interests), and reducing relationships (by selling noncore and poorly performing LPs). Newman said that of the $900 billion in new private equity commitments made in the past decade, only 1% to 3% each year will have been turned over to the secondary market. Finally, the panel noted that secondary purchases, although often labor-intensive, offer favorable risk-adjusted returns that, from the buyer's perspective, demonstrate less earnings volatility and shorter-term horizons.

As regulatory requirements for large financial institutions become broader and deeper, it is becoming increasingly important to develop more nuanced approaches to allocating economic capital. This poses a particular challenge when institutions own assets that do not trade, such as private equity. Rui J. P. de Figueiredo, University of California, Berkeley, Haas School of Business, discussed an approach being developed by Citigroup Alternative Investments for calculating the allocation of economic capital to private equity. Hurdles to developing metrics of reasonable accuracy include illiquidity, risk measurement in nontraded assets, calibration of returns (the liquidity premium), accounting for unusual distributional characteristics, and time aggregation.[4]

Managing risk

In private equity acquisitions, inherent financial, legal, managerial, and operational risks can often be difficult to

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unearth in the relatively short due diligence process. While no deal is completely risk free, a private equity fund can increase its success rate by identifying potential risks early enough to mitigate their potential effects. A panel of deal professionals, moderated by Steven Pinsky, J. H. Cohn LLP, addressed risk scenarios that may be discovered during due diligence. The panelists were Charles S. Detrizio, Riker Danzig Scherer Hyland & Perretti LLP; David J. Kaufman, Duane Morris LLP; Joseph C. Linnen, The Jordan Company; and Ward S. McNally, Edgewater Funds. They debated whether the various risks were acceptable, unacceptable ("deal breakers"), or controllable through either structuring or purchase agreement alternatives.

Banking organizations engaging in private equity activities face special compliance challenges compared with their nonbanking competitors. Douglas Seefus, Wachovia Capital Partners, moderated a panel on bank compliance since the Gramm–Leach–Bliley Act (GLBA). Panelists were Erick C. Christensen, Bank of America; Erin E. Hill, One Equity Partners; and John Oliva, JPMorgan Partners. The panel noted that greater supervisory oversight since the enactment of GLBA[5] has brought many benefits to financial holding companies, including closer integration of compliance functions with private equity business lines, independent reviews of valuations, and greater transparency and oversight of the business.

One topic discussed by the panel was the fact that private equity activities at banks may give rise to both actual and perceived conflicts of interest. Panelists provided insights into how they manage these conflicts. Oliva noted that JPMorgan Chase has structurally separated private equity from investment banking and established a formal office to address conflicts of interest on an enterprise-wide basis. Each firm represented provides clear guidance that portfolio companies are allowed to obtain investment or commercial banking services from any unaffiliated organization. In addition, no specific incentives are provided to private equity professionals for referring business to an affiliated broker-dealer.

The panel also discussed the challenges and growth opportunities of foreign investing. These include a political backlash in some European countries against foreign private equity firms, governance issues, enforceability of legal documents, information transparency, less sensitivity abroad to U.S. compliance issues, and repatriation of U.S. dollars invested.

Conclusion

In remarks highlighting compliance risk management, Cathy Lemieux, senior vice president, Federal Reserve Bank of Chicago, suggested that the private equity industry could reduce exposure to legal and reputational risks and head off unwanted regulation by practicing effective self-regulation. A firm's board and senior management should set the appropriate "tone at the top" by requiring a strong compliance culture that is well communicated and incorporated into the firm's day-to-day operations. In addition, firms should consider developing enterprise-wide compliance functions with the appropriate standing, authority, and independence to help senior management address the full range of compliance risks in a holistic manner. These sound corporate governance practices, which bank supervisors are encouraging at banking organizations, could also help private equity firms better navigate the shifting winds of risk.

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1 Details of the conference are available at www.chicagofed.org/news_and_conferences/conferences_and_events/2006_annual_private_equity_conference.cfm.

2 Neil Weinberg and Nathan Vardi, 2006, "Private inequity," *Forbes*, March 13.

3 See Roger McNamee with David Diamond, 2004, *The New Normal: Great Opportunities in a Time of Great Risk*, New York: Penguin. Also, see his blog at www.thenewnormal.com.

4 See Vineet Budhraja and Rui J. P. de Figueiredo Jr., 2005, "How risky are illiquid investments?," *Journal of Portfolio Management*, Winter.

5 Federal Reserve Board, Division of Banking Supervision and Regulation, 2000, "Supervisory guidance on equity investment and merchant banking activities," supervisory letter, No. SR 00-9, June 22.