ESSAYS ON ISSUES

THE FEDERAL RESERVE BANK OF CHICAGO

DECEMBER 2007
NUMBER 245a

Chicago Fed Letter

Has risk management in private equity kept pace with rapid growth?

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The Federal Reserve System's Private Equity Merchant Banking Knowledge Center, formed at the Chicago Fed in 2000 after the Gramm–Leach–Bliley Act was passed, sponsors an annual conference on new industry developments. This article summarizes the 2007 conference, Private Equity Has Gone Big … Has Risk Management Kept Pace?, held August 2–3.

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. The agenda for the conference is available at www.chicagofed.org/banking_information/2007_pemb_conference_agenda.pdf.

At the time of the conference, the private equity industry was facing a rapidly changing environment. Credit markets were becoming more restrictive and risk averse, turning away from the low interest rates and accommodative credit terms that had prevailed for several years and had facilitated rapid growth in private equity investing. Private equity firms were facing the prospect of fewer deals, higher borrowing costs, tighter terms, and a reduced availability of leverage.[1] They also risked losing their competitive edge compared with more-traditional, strategic buyers. A number of conference participants addressed these changes and their possible effects on private equity.

Current risks in private equity

In his opening remarks, Michael H. Moskow, then president and CEO, Federal Reserve Bank of Chicago, pointed out some of the ways that private equity has "gone big." These include high volumes of global mergers and acquisitions (M&A) activity and industry fundraising, large deal sizes and high deal prices, and greater use of leverage.

This asset class is also seeing some significant qualitative changes. Private equity buyout firms are targeting new types of industries, such as financial services firms, telecom companies, and "smokestack" industries. They are also increasingly seeking out companies in rapidly growing emerging markets and beginning to engage in hostile takeovers under select circumstances.

As private equity continues to grow and take new directions, it has begun to attract the attention of Congress and certain interest groups, including organized labor. The U.S. regulators have also articulated a regulatory philosophy for "private pools of capital," supporting the current regulatory structure and recommending continued reliance on sound risk-management practices.

Moskow next highlighted three top risks facing private equity. The first risk was heavy reliance on leverage, which makes target firms more vulnerable to rising interest rates and economic shocks; such reliance had been exacerbated (until just recently) by weaker underwriting. The second risk was potential conflicts of interest. In large complex organizations such as global banks, conflicts of interest can arise between private equity investing and other roles, such as lending and advising clients on M&A. The third risk was the lack of transparency, specifically the unclear ownership of economic risk. Should severe credit issues arise, it may be hard to determine who is ultimately at risk.

Furthermore, Moskow described how banks continue to be major participants in the industry by managing private equity funds; banks also continue to invest in these funds and provide loans and services to them. What is new, however, is that banks are beginning to emerge as targets in private equity deals—at least under certain special circumstances. Leverage and legal issues related to control and permissible activities continue to function as barriers to the expansion of private equity into banking.

In her welcoming remarks earlier, Cathy Lemieux, senior vice president, Federal Reserve Bank of Chicago, had mentioned an additional risk of private equity. She noted how credit risk had changed because of the evolution at many banking organizations from an "originate-and-hold" strategy to an "originate-to-distribute" strategy.[2] This shift has been driven by innovation in financial instruments and by rapid growth in institutional investors looking for loans to buy. One example of this change is the rise of "equity bridge loans," the interim financing banks provide on some private equity deals.

Overall, this evolution in lending has distributed risks more widely outside the banking system, and it has made risks, and the pricing of risks, more transparent. However, it has also generated new risks that are not well captured by traditional measures of risk.

Three key risks of private equity have been heavy reliance on leverage, conflicts of interest, and lack of transparency.

Current condition of the industry and of credit markets

John A. Canning, Jr., Madison Dearborn Partners, surveyed the current state of the private equity industry by providing extensive data on the heights that M&A volume, fundraising volume, and transaction size had reached in recent years. He also described how attractive capital markets had supported transactions that featured lower credit ratings and higher levels of leverage. Credit terms had also become more favorable to borrowers. These favorable terms included loans with no required amortization and loans with few or no restrictive covenants, known as "covenant-lite" loans.[3] However, recent changes in the credit markets are dramatically altering the picture, Canning said. He described these changes as a repricing of risk or market adjustment rather than as a "credit event" similar to the bursting of the Internet bubble earlier this decade.

Canning also described how public companies are continuing to go private. However, the dynamics of this process are changing, as boards of directors are becoming more assertive and the roles of other participants, such as management, private equity firms, and banks, are evolving in response to this assertiveness.

Finally, Canning highlighted the growing backlash against the recent "surge" in private equity activity. This backlash has come from many parties: the press, shareholders, sellers, regulators, labor unions, Congress, and boards of directors. To address this, Canning argued, the industry needs to become more transparent and to make a better case for the economic benefits produced by private equity.

Meredith W. Coffey, Reuters Loan Pricing Corporation, analyzed the relationship between leveraged loans and private equity, including long-term trends in the market for leveraged buyout (LBO) loans, as well as current market conditions. Global LBO lending had reached record levels, and average loan size had also grown dramatically in the first half of the current decade. Further, loan spreads had contracted materially, and leverage had increased significantly. Strong appetite for LBO loans from institutional investors had also facilitated the development of new types of loans.

More recently, Coffey said, credit markets have become skittish, in part because of worries related to subprime mortgages. This coincided with a huge supply of leveraged loans coming to market. The pipeline of leveraged loans was much larger than ever before, and many of these loans were covenant-lite. In recent months, prices for leveraged loans have been falling sharply across the secondary market.[4]

Although default rates, both actual and projected, remain benign, Coffey said, pricing behavior suggests that the market is experiencing a significant oversupply, an aversion to covenant-lite loans, and an upward repricing of risk.

Key components of the private equity process

Several of the conference sessions were dedicated to key components of the private equity process: fundraising, due diligence, and exit strategies using the secondary market. The fundraising panel was moderated by John K. Kim, Court Square Capital Partners, and it featured Beverly Berman, Advent International; Michael Bolner, Citigroup Alternative Investments; J. Michael Ireland, Newbury Partners; and Dale J. Meyer, KRG Capital Partners. One newer development in fundraising is the rise of "megafunds." In the 1980s, a fund in the $200 million–$300 million range would have been considered large; now funds can be over $20 billion. The largest funds continue to enjoy advantages in fundraising, with "name brand" identity and ready access to all sources of capital. In addition, institutional investors with small staffs (such as some public pension funds) cannot manage a large number of fund relationships, so they work with the largest firms exclusively to attain a certain portfolio size level.

The panelists said they expected public pension funds to keep growing in importance to the industry. Venture capital gains in recent years have been shared more broadly than in past cycles, generating more support for fundraising. In addition, many public (and other) pension funds face issues of underfunding and are attracted to the steep returns provided by alternative investments, including private equity. Finally, this source of fundraising is only beginning to be tapped, with some state investors still lacking any allocation in alternative investments.

The limited partnership structure is critical to the fundraising process, but

long-term returns vary substantially by type of limited partner. Joshua Lerner, Harvard Business School, presented results of studies showing that endowments (such as universities') typically outperform other limited partners.[5] However, banks and corporate pension funds underperform sharply. Four hypotheses may explain the superior performance of endowments. First, endowments have succeeded in cultivating a "longer-run" outlook. Second, many endowments have had stable private equity teams over many years, despite seemingly modest levels of compensation. Third, many endowments carefully analyze the success or failure of past investment decisions and try to incorporate the lessons learned in subsequent decisions. Fourth, effective endowment committees are willing to delegate fund decision-making to staff and are able to provide objective insights into longer-term market trends.

In today's private equity marketplace, it is critical to understand the trends driving tomorrow's decisions and to tailor due diligence accordingly. A panel representing both the fund sponsor and investment banking perspectives presented results of a survey conducted in June 2007 of 90 middle-market M&A professionals. The panel was moderated by Steven Pinsky, J. H. Cohn, and it included Robert P. Crisp, Crowe Capital; Warren H. Feder, Carl Marks Advisory Group; Brian Gallagher, Twin Bridge Capital Partners; Martin Magida, Trenwith Securities; James P. Marra, Blue Point Capital Partners; and Thomas M. Turmell, Golub Capital Incorporated. The survey responses demonstrated a wide range of opinions. For example, many respondents felt that management and investigations was the most overlooked area of due diligence, while many others chose human resources and benefits. A majority of respondents indicated that due diligence in the financial and accounting area provided the best return on dollars spent.

Exit strategies using the secondary market remain an important part of the private equity process. The secondary market panel—moderated by Stephen H. Can, Credit Suisse Strategic Partners—featured Edward Hortick, VCFA Group, and Jerrold M. Newman, Willowridge Incorporated. According to Hortick, the secondary market is still a small part (roughly 2% to 3%) of the total private equity market but represents an important risk-management tool. He outlined the advantages of using the secondary market, such as realizing balance-sheet optimization strategies, and the risk implications of various transaction structures.

Newman provided a detailed description of the deal-making process, which has historically been fairly labor-intensive for both the buyer and seller. Finally, Can talked about leverage. Secondary fund investing is characterized by relatively thin returns, and the addition of leverage makes these returns vulnerable to delays in sale and/or decreases in exit valuations. In summary, Can stated that leverage on leverage on leverage (that is, primary fund leverage, secondary fund leverage, and secondary limited-partner leverage) materially magnifies risk, return volatility, and outcomes.

Globalization

More domestic fund managers are looking at global investment opportunities. Susan E. Boedy, Thunderbird School of Global Management, moderated a panel on globalization, featuring Beverly Berman, Advent International; John Crocker, Citigroup; and David A. Posner, Calder Capital Partners. Boedy noted that, among emerging markets, Asia continues to generate the highest overall level of private equity fundraising, although Latin America and sub-Saharan Africa showed the most dramatic growth in fundraising in 2006. She listed a wide range of investment challenges and risks related to global investing, including the lack of transparency, the need for an entrepreneurial culture, economic instability, shareholder protection concerns, restrictive labor laws, and fragmented capital markets.

Crocker explained that buyout and growth funds dominate in Asia, where fundraising has been stimulated by expected rates of return much higher than those available in the U.S. Berman discussed how attractive pricing and the improving economic environment are stimulating private equity investment in Latin America. Posner reported that buyouts in Europe have been vibrant, while venture capital has been less successful. Russia is becoming a more receptive environment because of its good economic indicators, the emergence of a genuine middle class, and an expanding consumer market. Finally, Boedy noted that growth opportunities in the Middle East and Africa stem from increasing liquidity related to rising oil prices, government privatization efforts, and rising numbers of high-net-worth individuals.

The changing world of alternative investments

Alternative investments include private equity, hedge funds, real estate, and commodities. Robert J. Caruso, Highbridge Capital Management, and Faith Rosenfeld, Highbridge Principal Strategies, analyzed the growing convergence (that is, the blurring of boundaries) between hedge funds and private equity. Some hedge funds are pursuing this convergence because they need a place to deploy their growing fund assets. Some private equity funds are pursuing it because they want to realize gains in a more timely fashion.

Caruso and Rosenfeld described this convergence as a long-term, permanent change. The highest-quality and largest private equity and hedge funds will

Charles L. Evans, *President*; Daniel G. Sullivan, *Senior Vice President and Director of Research*; Douglas Evanoff, *Vice President, financial studies*; Jonas Fisher, *Economic Advisor and Team Leader, macroeconomic policy research*; Richard Porter, *Vice President, payment studies*; Daniel Aaronson, *Economic Advisor and Team Leader, microeconomic policy research*; William Testa, *Vice President, regional programs, and Economics Editor*; Helen O'D. Koshy, Kathryn Moran, and Han Y. Choi, *Editors*; Rita Molloy and Julia Baker, *Production Editors*.

Chicago Fed Letter is published monthly by the Research Department of the Federal Reserve Bank of Chicago. The views expressed are the authors' and are not necessarily those of the Federal Reserve Bank of Chicago or the Federal Reserve System.

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ISSN 0895-0164

continue to pursue this strategy to create larger alternative asset management firms that will increasingly dominate the market. Corporate governance and internal processes—including the ability to manage conflicts of interest and potential compliance issues—will be critical to their success.

The Securities and Exchange Commission (SEC) has traditionally focused on U.S. public companies; the registered investment companies, investment advisors, and broker-dealers; and their U.S. investors and customers. However, globalization and the increasing integration of financial markets have led the SEC to consider many other players in the capital markets. In his keynote speech,[6] SEC Commissioner Paul S. Atkins addressed some of these new departures.

After a 2004 rule requiring registration for hedge fund advisors was overturned in the courts, the SEC has taken a different approach to unregistered funds. First, the SEC is intensifying its cooperation with other regulators and supervisors on issues of systemic risk and information collection. Second, it has proposed rules raising the wealth threshold for investors in private pools of capital. Third, the SEC has adopted a rule to clarify that it can pursue fund advisors for fraud.

A look back and a look ahead

Timothy G. Kelly, Adams Street Partners, concluded the conference with a wide-ranging discussion touching on many issues addressed by earlier speakers. His talk covered the history of private equity since the 1980s and was organized around the contrasting mind-sets of “denial,” “anger and resistance,” “exploration and acceptance,” and “commitment.”

To put current developments in perspective, Kelly highlighted a number of major differences between the current buyout expansion and the earlier Internet and telecom expansion, circa 2000. Positive aspects of the current situation include operating headroom provided by covenant-lite debt, more-viable companies that can respond to reduced funding by rationalizing expenses, and the availability of exit strategies, including strategic buyers. Based on these differences, he suggested that, while private equity returns may suffer in the short term, the buyout sector should be able to weather the storm. He cited the following factors that could make the storm significantly more difficult to weather: a prolonged capital markets dislocation, the tightening credit market, overly expensive target firms, the reemergence of strategic buyers, an earnings slowdown, government regulation, and/or major industry losses.

At next year’s conference, it will be interesting to see how the private equity industry has adapted to its dramatically changed environment and whether risk management has, in fact, kept pace with rapid growth.

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[1] Leverage refers to the use of debt to increase the potential return on an investment.

[2] The traditional “originate-and-hold” strategy involved originating loans and holding them on the balance sheet until they were repaid or written off. The more recent “originate-to-distribute” strategy allows banks to sell loans (and the underlying risks) to final investors, such as pension funds, insurance companies, and hedge funds.

[3] A covenant is a promise in a debt agreement that certain conditions will or will not be met; the purpose is to protect the lender.

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

[5] For more information, see Josh Lerner, Antoinette Schoar, and Wan Wong, 2007 “Smart institutions, foolish choices?: The limited partner performance puzzle,” *Journal of Finance*, Vol. 62, No. 2, April, pp. 731–764.

[6] This speech is available on the SEC’s website: www.sec.gov/news/speech/2007/spch080207psa.htm.