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Navigating the New World of Private Equity—A conference summary

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The Federal Reserve System's Private Equity Merchant Banking Knowledge Center, formed at the Chicago Fed in 2000 shortly after the passage of the Gramm–Leach–Bliley Act, sponsors an annual conference on new industry developments. This article summarizes the 2008 conference held on July 9–10.

The current financial environment presents both challenges and opportunities for private equity firms.

To begin our 2008 conference, Carl Tannenbaum, vice president, Federal Reserve Bank of Chicago, offered some broad remarks on the financial environment and how it has affected private equity.[1] The recent financial turmoil has dramatically altered the landscape for private equity, particularly in the buyout sector.[2] The diminished outlook for corporate profitability has altered projected returns and payback periods for investments in both the public and private domains. Leverage is less available and less attractive as a financing source for transactions.[3] Financial institutions have reacted to stress on their balance sheets by tightening terms, raising prices, and reducing the availability of credit.

Despite these challenges, Tannenbaum noted that the faltering economy and the perception that investors may have overreacted to it have broadened the pool of opportunities for private equity firms. Newer opportunities include investing in financial institutions and clean technology and buying distressed loans and securities.[4] In this way, private equity firms have contributed to restoring markets and economic activity to normality.

New landscape of private equity

Avy Stein, of Willis Stein and Partners, surveyed the current state of the private equity industry. Fundraising for both buyout and mezzanine funds is still solid.[5] However, the amount being invested in private equity deals is considerably below the level of last year; this is due to the absence of large deals. The current market is characterized by lower leverage, lower deal volume, different investment strategies, and greater difficulty in finding exit opportunities.

According to Stein, lenders are working through the huge backlog of leveraged loans they were unable to distribute in the latter part of 2007. Solutions to this backlog are beginning to take shape, including sales of these loans to private equity firms, write-offs, development of new funding vehicles, and the raising of extensive amounts of new capital by the banking industry.

Some private equity firms, Stein said, have altered their investment strategies to reflect the changed realities. Such firms are currently emphasizing the middle market,[6] minority (noncontrolling) investments, public companies, emerging markets, leveraged loans and other debt instruments, and distressed securities.

Looking ahead, Stein argued that private equity is becoming a mature market, with increasing segmentation and competition. Reputational concerns surrounding

the image of private equity will persist. Finally, skilled operating management of portfolio companies will continue to be the most important ingredient for success in private equity.

To succeed in the current private equity marketplace, it is important to recognize and understand the trends driving tomorrow's decisions, as well as the perceptions of peer investors, and to tailor strategies accordingly. A panel led by Steven Pinsky, of J. H. Cohn LLP, explored industry professionals' perceptions of the current environment. The panelists included Brian Gallagher, Twin Bridge Capital Partners; Thomas Janes, Lincolnshire Management; Joseph Linnen, The Jordan Company; and Martin Magida, Trenwith Group. The panel presented and discussed survey findings and industry statistics on mergers and acquisitions (M&A) and sector trends, valuations, and fundraising. For example, over the past year the industry with the highest value of private equity placement was the financial sector; energy, health care, and financials are expected to be the three "hottest" industries over the next year. In addition, the consensus among panelists was that valuations will continue to trend lower, and lower leverage ratios will continue to be a factor for the next year.

Ghia Griarte, Saints Capital, presented trends in the secondary market for private equity.[7] Over the past few years, this market has grown rapidly, with the types of sellers and the industry sectors represented becoming much more diverse. Currently, limited partners (LPs) and general partners (GPs) are increasingly adopting the secondary market as a portfolio management tool. With traditional exit markets largely closed by the recent financial turmoil and overall markets set for a slowdown, secondary-market firms expect to benefit from the cycle in the coming years. However, continued downward pressure on secondary-market pricing is expected.

The limited partners' perspectives on the current landscape of private equity were explored by a diverse panel. The panel was moderated by John Kim, Court Square Capital Partners, and featured Michael Dutton, California Public Employees' Retirement System; Saleena Goel, AlpInvest Partners; John Morris, HarbourVest Partners; and Jen Wilson, Thrivent Financial. Panelists indicated that staff size and required expertise at LPs varied widely, depending on each LP's strategy. They generally agreed that compensation should be based on investment results. Regarding selection of GPs, LPs generally want to pick the top-quartile or top-decile performers, but to do this they need to develop a thorough understanding of all the players based on independent research into specific transactions.

> The private equity industry is working to define its place in the financial landscape, both domestically and internationally.

Sovereign wealth funds are becoming increasingly prominent in the environment of private equity.[8] These funds are quite diverse in their age, size, expertise, and potential impact. Finally, hedge fund and private equity fund strategies continue to converge in a number of areas, including investing in distressed securities.[9]

Leveraged finance market

The supply and terms of leveraged finance are critical determinants of the level of buyout activity. Meredith Coffey, Thomson Reuters, surveyed recent trends and prospects in this market. In the past few years, money has poured into this asset class, causing it to grow rapidly and U.S. merger financing, especially in buyouts, to hit record levels.

In the third quarter of 2007, the supply of leveraged loans peaked, just as demand was evaporating as part of the spreading financial turmoil. The resulting sharp drop in loan prices was followed by another one in early 2008, as accounting rules requiring write-downs to currently depressed market values triggered a vicious cycle of loan sales and further price declines. Consequently, loan prices in recent months have shown an unprecedented volatility. In addition, the volume of U.S. M&A lending has fallen sharply, with leveraged buyouts (LBOs) hit hardest. Currently, LBO loans are smaller, yields on these loans have soared (reflecting greater risk aversion), and leverage multiples have contracted slightly.

In the second quarter of this year, the loan market rallied sharply. However, secondary-market prices of LBO loans, "covenant-lite" loans, and second-lien loans are still depressed.[10] Currently, lenders are more worried about the state of the economy and the prospect of rising defaults than about supply–demand imbalances and market disruptions. In some ways, the buyout market resembles the conditions last seen in the early to mid-1990s.

New investment strategies

In the current environment, traditional private equity funds are adjusting their strategies to become more opportunistic, investing in combinations of private equity stages (e.g., start-ups as well as more-established companies) or even hedge funds and nonequity instruments. Even funds that have stayed with private portfolio companies are venturing into new industry sectors. A panel of GP and LP investors explored some of these "hybrid" fund strategies. The panel was moderated by Sajan Thomas, of Thomas Capital Group, and it featured Edward Hortick, VCFA Group; William Ruh, Castle Creek Capital; and Elizabeth Tulach, The Boeing Company.

With regard to new sectors, the U.S. financial industry will continue to need considerable infusions of new capital. This includes small- and mid-sized banks, which are easier for investors to evaluate than the more-opaque large banks. Panelists also reported considerable interest in infrastructure and natural resources investments. The longer-term nature of these projects can be suitable for certain investors with long-term liabilities (e.g., pension funds). Still, whenever strategic shifts (such as the more recent interest in clean technology) are dictated by adverse market conditions, there is a risk that fund managers may venture too far from their proven strengths.

In the first luncheon keynote address, Jacques Nasser, One Equity Partners (and former president and CEO of the Ford Motor Company), explored private equity investment strategies that target the auto industry. This industry is being adversely affected by many trends in the current economy, including high energy and commodity prices, falling consumer confidence, and tighter credit. However, each of the three segments of the auto industry (manufacturers, suppliers, and dealers) has significant structural and operational weaknesses that could present opportunities for private equity firms. Nasser also proposed a broader and longer-term strategy—with investments in a range of new technologies that would benefit energy security and environmental protection while generating profits for both the automotive sector and the private equity industry at large.

Globalization continues

Private equity firms continue to explore new opportunities in Europe. Susan Boedy, Thunderbird School of Global Management, moderated a panel on the subject, and it included Paul Carbone, Baird Private Equity; Kurt Geiger, formerly of the European Bank for Reconstruction and Development; Mark O'Hare, Private Equity Intelligence; and Helge Petermann, Capital Dynamics. European funds have delivered strong returns for many years. Private equity investment in Europe is roughly similar to the amount invested in the U.S., but the European market is much more complex and differentiated by region and country. For instance, Eastern Europe continues to demonstrate strong demand for private equity, particularly for the growth and expansion capital variety, yet many regions in Europe remain underpenetrated by private equity. In 2007, European fundraising was dominated by buyout, real estate, infrastructure, and mezzanine funds. The regulatory environment varies considerably by country, with the UK generally favoring industry self-regulation and countries on the continent favoring more direct government regulation.

Venture capital is relatively underdeveloped in Europe. Panelists attributed this to the general lack of geographical clusters that combine human and financial capital, technology, entrepreneurship, and academia (such as Silicon Valley in the U.S.). European returns have yet to be significantly affected by the credit crunch. Regarding the future, the large number of family-owned European firms with succession issues presents great opportunities, particularly for buyouts. However, European countries often have structural impediments to private equity strategies, such as restrictive labor laws. Panelists agreed on the need to find experienced local partners in order to successfully navigate the complexities of European markets.

Another panel focused on the rapidly emerging market of China. This panel was moderated by John Crocker, Citigroup, and featured Christopher Lane Davis, of McCarter and English; Gary Lawrence, Excelsior Capital Asia; Eugene Pohren, PCG International; and Andrew Rice, The Jordan Company. According to Crocker, private equity investments in China in 2007 totaled $12.8 billion, roughly matching 2006 levels; the number of deals increased in 2007 by 37%, to 177. China's legal and regulatory environment is developing to foster increased private equity investment in the years to come. However, significant barriers exist that discourage traditional foreign investment. These hindrances include cultural issues, banking sector problems, discrepancies in the legal system, and government restrictions. Lawrence described how government policy is shifting toward greater energy efficiency and environmental protection, more investment to reduce income disparities, and development of the financial sector.

According to Pohren, in 2007 early stage/growth capital strategies represented 38% of private equity investment in China, with buyouts representing only 13%. Rice explained how Chinese companies have been looking to foreign partners not only for capital but also for guidance regarding controls and procedures to help them become world-class global suppliers. Finally, Davis profiled the relatively small venture capital segment of the market that is created by government entities, which differs markedly from venture capital in the U.S. and other developed economies.

Management of conflicts of interest and spinoffs

Private equity investing coupled with other business activities, especially within banking organizations, inherently generates many potential conflicts of interest. Managing these conflicts is an essential element in reducing legal and reputational risks. Kenneth Wilcox, SVB Financial Group, discussed how his firm (a bank holding company headquartered in Silicon Valley) addresses these issues.

Wilcox detailed a wide range of potential conflicts of interests that can arise in his organization. For example, the pursuit of LP interests could be contrary to corporate shareholder interest (and vice versa), or the pursuit of personal interests by employees could hurt shareholders or LPs. Key defenses against conflicts are clearly defined responsibilities and separation of duties, clear prohibitions, clear incentives, an appropriate "tone at the top," a strong culture of ethics, and severe and immediate consequences for policy violations.

For strategic reasons or as a result of merger consolidations, management teams responsible for private equity activities are often "spun off" from banks and other financial institutions. A panel, moderated

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, *Vice President, 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*.

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by Timothy Kelly, Adams Street Partners, explored some of the risks and trade-offs associated with spinoffs. The panelists, all formerly part of large banking organizations, were Timothy Dugan, Water Street Healthcare Partners; David Gezon, Midwest Mezzanine Funds; Marc Unger, CCMP Capital; and Fernando Vazquez, Conversus Asset Management. One key issue in spinoffs is staffing—i.e., determining who stays and who goes. Another point of negotiation and interpretation is attribution: Who will get credit for the track record of the portfolio—the owner organization or the spinoff's management team?

Panelists noted a number of advantages that may result from no longer being part of a large organization. These include greater accountability for individual performance, clearer lines of decision-making, fewer disruptions from strategic changes in the larger organization, and a reduced direct compliance burden. However, Unger noted that in his firm, the now independent management team has to maintain its pre-existing compliance regime as a subadvisor to the bank, along with adhering to requirements as a newly established registered investment advisor.[11]

One key disadvantage was the loss of a wide range of support services previously provided by the parent organization. In a private ownership structure, these services need to be obtained individually from many different providers. Beyond that, Vazquez noted the need to transition brand recognition, as well as the need for the spinoff group to create the broad capabilities and networks of the former parent organization.

Conclusion: Evolution of the private equity asset class

In the second luncheon keynote address, Gary Fencik, Adams Street Partners, examined how private equity evolved to its current state. After the third straight year of record buyout fundraising in 2007, the current year will most likely see a decline. Buyout activity, especially at the large end, ground to an abrupt halt in the second half of 2007. Record high purchase price multiples should come down as the credit crunch adjusts prices that buyout firms are willing to offer. With sharply higher credit spreads and lower leverage multiples, future buyout returns will be lower. Finally, global venture capital fundraising has declined significantly, and venture-backed initial public offering activity has been virtually nonexistent.

Overall, the conference provided a picture of an industry actively reinventing itself in the face of a much less favorable environment. It remains to be seen how well the private equity professionals will be able to successfully navigate the risks and opportunities of this new world.

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[1] 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.

[2] Buyout funds are a sector of the private equity industry that focuses on the purchase of controlling interests in established companies.

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

[4] These are loans and securities of companies undergoing (or expected to undergo) bankruptcy or restructuring in an effort to avoid insolvency.

[5] Mezzanine funds are a layer of financing that has intermediate priority (seniority) in the capital structure of a company.

[6] The middle market comprises medium-sized companies, usually defined as those with ten to 100 employees and revenues of $10 million to $50 million.

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

[8] Sovereign wealth funds are investment funds owned by a national or state government.

[9] Hedge funds are funds (usually used by wealthy individuals and institutions) that are allowed to use aggressive strategies unavailable to mutual funds.

[10] Covenant-lite loans are loans with few or no restrictive covenants; covenants are promises in a debt agreement (intended to protect the lender) that certain conditions will or will not be met. Second-lien loans are leveraged loans secured by a second lien on assets.

[11] A registered investment advisor is a party, registered with the Securities and Exchange Commission and respective state(s) of operation, that manages assets or provides investment advice.