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2013 Wharton Private Equity Review:

Navigating the 'New Normal'

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2013 Wharton Private Equity Review:
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Some $200 billion of new capital went to private equity and venture capital management partnerships (collectively referred to here as PE) throughout the world in 2012. For the first time, 20% of that total, some $40 billion, went to fund managers in emerging market countries. Surprisingly, of that $40 billion, only $15 billion went to the subset of emerging economies known as the BRICs (Brazil, Russia, India and China). That leaves $25 billion that went into the non-BRIC emerging markets.

So where did the rest of it go? Countries like Columbia, Chile, Peru and Mexico have seen remarkable growth. Several African countries, such as South Africa, Kenya and Nigeria — indeed, the whole of sub-Saharan Africa — have witnessed growth in the number of fund managers and the capital under management. Turkey also has emerged as a destination, as have Malaysia, Thailand, Vietnam and now Indonesia.

These new players still have work to do in improving their PE ecosystems. Management capacity building is high on the list, as are appropriate laws and regulations, tax treatment and acceptance of contractual provisions. These countries' governments have recognized the role of PE in their industries and are motivated to make the needed changes. There is a discernible transfer of knowledge from mature economies to the emerged and emerging market PE players.

These trends are reflected in two of the articles included in this year's *Wharton Private Equity Review*. One offers coverage of a panel discussion titled, "Private Equity Survival Guide: How to Survive and Thrive in Emerging Markets," which took place at the 2013 Wharton Private Equity & Venture Capital Conference. The second, written by a team of five Wharton MBA students, focuses on the impact of the Arab Spring on private equity in the Middle East and North Africa (MENA) region.

Beyond emerging markets, this year's review includes a piece by a Wharton MBA student that looks at how the regulatory scrutiny of the PE industry in the United States has evolved dramatically over recent years. The industry has moved from a lightly regulated, self-governing asset class to one that is coming under increasing scrutiny and reporting requirements. The author speculates on what is in store for the industry as regulators continue their investigations.

An example of international activity is presented in a case study by another Wharton MBA student, titled "Investing in Times of Distress: the Bank of Ireland and WL Ross," which provides a detailed overview of how PE investors have played a role in the recapitalization and restructuring of troubled financial institutions.

Knowledge@Wharton then reports on another panel from the conference that addressed how PE firms create value and questioned some of the common wisdom surrounding the roles and actions of PE firms once they have acquired a company. Finally, a piece on venture capital from another conference panel then looks at the challenge of generating consistent returns and the growing allure of New York City over Silicon Valley.

The story of PE and venture capital in mature economies and the emerging markets does not end here. PE activity has now blossomed in virtually every region and is reinvigorating entrepreneurship, companies and entire industrial sectors. We hope that we have captured some of this excitement and challenged preconceptions at the same time.

— Stephen M. Sammut, Senior Fellow, Wharton Health Care Management and Lecturer, Wharton Entrepreneurship

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Fast-growing Middle Classes in Emerging Markets Lure Private Equity

"Emerging markets" is a catch-all term that tends to suggest outsized risks and the potential for outsized investment returns. But for private equity (PE) firms, this broad term masks the wide-ranging differences between distinctive markets. Large emerging countries like China and India are very different from smaller ones like Bolivia and Paraguay.

So how do PE firms that specialize in emerging markets find opportunities that justify the risks? It's not an exact science, according to speakers who participated in a panel discussion on emerging markets at the 2013 Wharton Private Equity & Venture Capital Conference, but the most appealing markets do share some characteristics, like a growing middle class and business-friendly government.

Some countries, such as Brazil, Russia, China and India (which are also known as the BRICs), are obviously further along in the process of emerging than others, and have a track record of profitable PE investments as an indicator of their market's potential, said Ralph Keitel, principal investment officer of the International Finance Corp. (IFC), the private sector arm of the World Bank Group that invests in PE funds. The IFC invests $12 billion to $15 billion a year, and has a dual goal of earning investment returns and aiding economic development in emerging markets.

Understanding a country's pros and cons takes a "granular" examination, he added, because a single country may be relatively well developed in some geographical regions, "whereas 500 miles to the north or south, people are living in abject poverty." China is a prime example, he pointed out, with vast differences between the developed coastal cities and the poor rural inland areas. It would be a mistake to assume that all of China presents great PE opportunities.

Emerging markets that appeal to PE firms do tend to share some other features as well, said Enrique Bascur, managing partner of Citigroup Venture Capital International (CVCI). "The one thing that they have in common is a higher than average growth rate," he noted. But a high growth rate is not enough if the country's economy is small, he added. That is why countries like Brazil, Mexico, Chile, Peru and Columbia are attractive, but Bolivia and Paraguay are not.

Health Care Opportunities in Emerging Markets

Stephen M. Sammut, a Wharton lecturer and partner at Burrill & Company, a venture capital firm focused on the life sciences and health care, said his firm looks for markets that offer "growth and consolidation of the middle class." They also look for markets where "it is clear that the government policies are moving toward seeing health as a human right." A good market has a culture that encourages innovation and offers a favorable legal environment that provides basics such as contract enforcement, he noted.

Burrill also looks for countries that already have an established foundation in health care, he said. For example, India has a thriving generic medication industry eager to do research, and the government has made it easier for medical research firms to conduct drug trials, Sammut noted.

Keitel said the IFC prefers to invest in a business that, instead of doing what its competitors are doing, can move to the next level. Some markets, for instance, have companies that provide raw materials for medications, and the IFC tries to help them develop the expertise to produce finished products. A firm in one country might produce a drug, while a firm in another makes the syringe needed to administer it. "That would be an example of how we see various parts of East Asia work together," he said.

Different Markets, Different Strategies

The key to PE success in emerging markets is the ability to adapt, according to Keitel. Investors must be able to adapt to wide variations that distinguish one market from another. "Cookie-cutting in emerging markets is not a good strategy," he said. "We believe all business is local. We want to back [general partners] who have a very deep understanding of the market, who understand the culture, who have networks there."

For example, it takes very different strategies to invest successfully in Central America, where the capital markets are undeveloped, compared to South Africa, which has well-established capital markets and a fairly well-developed PE industry, said Keitel.

Business cultures also differ from one region to another, he added. In China and India, the PE firm often takes a minority stake because, for the target company's founder, "retaining control is a very important issue." It's more common for PE firms to take a controlling stake when they operate in Latin America, he noted.

On-the-Ground Presence is Optional

While it is important to have a deep understanding of local markets, this doesn't necessarily mean a PE firm must set up an office in every country in which it operates, said Bascur. "You can have an office there and *not* be local ... or be outside and understand it perfectly well," he explained. CVCI prefers to set up hub offices that serve multiple countries, he noted. These offices have the size, or "critical mass," that allows them to work more effectively compared to a multitude of small offices with skimpy resources. Typically, the hub is staffed by people from the various countries it serves, added Bascur.

While a country at the early stages of emerging might seem like virgin territory that is ripe with opportunity, it can be useful to have company in the PE space, Sammut observed, noting that indigenous PE funds are now forming in some emerging markets. "In my view, that's been a very positive trend," he said.

Much is often made of the risks of investing in emerging markets. There can be unstable currencies and governments, shaky legal systems, corruption and even warfare. But a closer look often reveals a difference between "perceived risk and real risk," Keitel said. Revolutions in Cairo and Tunis made headlines around the world, but had little effect on PE firms' operations in those cities, he pointed out.

A PE Home Run

The panel's moderator, Timothy J. Hartnett, leader of the U.S. private equity sector at PwC, an auditing and consulting firm, asked for examples of home runs in emerging markets.

Bascur provided one stand-out example: in the early 2000s, CVCI was approached by investment bankers seeking a buyer for a family-owned salt mine in Chile. In the wake of the Internet boom, this seemed like an out-of-the-ordinary opportunity that was about as low-tech as a business can get.

"This salt mine happened to be in the most economical place in the world to produce pure salt," he recalled. The salt lay on the surface only about 10 miles from the ocean, in a place where it almost never rains. Because this salt was so cheap to produce, CVCI saw a chance to capture a large share of the U.S. market for road salt for municipalities, airports and other big users.

The salt mine was purchased for $100 million, and CVCI then bought a Brazilian distribution company to help get the salt to market. After a few years, the operation had captured about 50% of the U.S. road salt market, and the firm was sold for $500 million.

This case was a classic example of an emerging market PE strategy that brought together firms in different emerging markets to serve customers in developed ones, he said.

The Arab Spring and Private Equity: Time to Take the Plunge?

Starting in the spring of 2011, the Middle East and North Africa (MENA) experienced a wave of protests, revolutions and even civil wars that continue to this day in some parts of the region. The Arab Spring has led to four governments being overthrown across the region, and many others offering political and economic concessions to their populations in response to growing disturbances and unrest. While uncertainty has grown for the entire region, many observers believe that greater stability will eventually bring about democratic governments and reform.

How has the Arab Spring affected the private equity (PE) industry in the MENA region, particularly in regards to investor appetite, investment decisions, fundraising, competition and global attitudes? What are the future investment prospects and what kinds of investors stand to benefit from the Arab Spring upheavals? Below are some insights:

A Time for Reform and a Time to Rebuild

Developing markets generally present PE investors with many challenges, including under-developed intellectual property rights protections, poorly functioning financial markets and a lack of public infrastructure. These issues, combined with the social and political unrest in the MENA region, would suggest a poor environment for private equity. According to data from consulting firm Geopolicity, unrest related to the Arab Spring is estimated to have directly wiped out billions of dollars from the region's gross domestic product (GDP).

But surprisingly, MENA private equity practitioners have been cautiously optimistic. The Arab Spring was spurred primarily by the population's disenchantment with the region's autocratic governments, political policies and economics. Resulting political and economic reforms will require billions of dollars of public investment, which could potentially pave the path for a more private equity-friendly future.

The full cost of repairing the damage and instituting massive reforms in the Maghreb region alone is expected to be $300 billion over the next 10 years, according to a an article in *La Maghreb Daily.* Saudi Arabia has already enacted a wider public investment and transfer payment program that is estimated to have cost $30 billion, the International Monetary Fund (IMF) reported.

Substantial foreign aid is also expected: The G8 pledged $20 billion to Egypt and Tunisia during the May 2011 Deauville summit, and the oil-rich nations from the Gulf Cooperation Council pledged an additional $20 billion to help Oman and Bahrain. In addition, the IMF pledged $35 billion to emerging Arab democracies, and is already in the process of disbursing loans. Thankfully for institutional investors, the IMF money comes with strict terms about how these funds should be used, and these policies will likely benefit investors.

It is worth noting that while a large part of the investment opportunity stemming from the Arab Spring revolves around direct spending and aid increases, the political and social reforms are arguably more important. The MENA region represents a huge market with an aggregate GDP of $2.5 trillion that is comprised of many autocratic states where PE faced difficult conditions well in advance of the Arab Spring. Even without any direct spending increases, simply gaining access to these markets represents a huge win for PE.

For example, in Morocco, the monarchy gave up its divine rights and introduced a new constitution that better shields the country's citizens — and investors — from autocratic capriciousness. In Egypt, the fall of former President Hosni Mubarak has opened up unprecedented personal and economic liberties that could potentially result in a better distribution of wealth and power, more reliable civil institutions and pave the way for growth in consumption and investment.

A key realization is that business opportunities in the MENA region were significantly depressed relative to developed markets because risk-takers could not reliably build businesses in the political climate that existed pre-Arab Spring. Furthermore, non-oil-rich MENA nations were relatively inaccessible and citizens were very poor, which is not ideal for investors. When starting from such a beleaguered base, the prospect of public investment, foreign aid and socio-economic liberalization paves the way for significant opportunities for patient investors. But how have PE investors fared thus far, and how will they participate in the MENA economy going forward?

The Arab Spring and Private Equity

Although there is no proof for causation, recent data from the Emerging Markets Private Equity Association (EMPEA) and the IMF seem to indicate that both economic growth and private equity investments in MENA decreased in the first year of the Arab Spring at a much faster rate than in developing economies that were not affected by such unrest.

IMF data shows GDP in 2011 in emerging markets grew by an average rate of 6% as opposed to only 3% in the MENA region. GDP growth was slowing in all emerging markets and developing economies at this time, but it was far worse in the MENA region.

Furthermore, according to the EMPEA, the capital invested in 2011 in the MENA region amounted to $385 million, down 52% from 2010. The number of deals that were closed, however, stayed relatively the same: 23 in 2010 versus 22 in 2011, which suggests that it was the size of the deals that ultimately changed. Indeed, the data shows there were a handful of investments in 2010 that exceeded $300 million, but no large deals in 2011.

Since 2011, the data points to signs of a recovery in the PE investment landscape. "After a subdued year for fundraising and investment activity in 2011, private equity in the MENA region exhibited signs of recovery in 2012, with new capital commitments and capital invested increasing by 29% and 303%, respectively," noted a recent EMPEA report.

"The upswing in investment can largely be attributed to an $855 million equity infusion in Dubai-based Shelf Drilling by the consortium of CHAMP Private Equity, Castle Harlan and Lime Rock Partners. However, the total number of MENA investments doubled in 2012, with most of the increased deal flow in the venture capital and small- and medium-sized enterprise market segments," stated the EMPEA.

According to data from business intelligence site Zawya, deals worth $362 million were closed in the first six months of 2012, compared to only $46 million in the same period a year prior, which was during the height of the Arab Spring revolutions.

PE professionals agree that a recovery has started. MENA-focused PE fund Amwal AlKhaleej has noted that, in the short term, the Arab Spring increased risk premiums and decreased liquidity and valuations, but now risk premiums are declining and liquidity is staging a recovery. It seems the region has also become more attractive to incumbent investors due to lower levels of competition. "We see Egypt as more favorable than before the revolution because the competition has backed off," Romen Mathieu of the Lebanese fund EuroMena II, said in an interview with the *Economist* magazine.

Furthermore, a February 2013 survey by the Economist Intelligence Unit (EIU) shows executives have an overwhelmingly positive business outlook for the MENA region. "Executives in the Middle East and Africa are particularly upbeat. More than a third believe business conditions will improve during the next six months; almost two-thirds expect their firm to boost capital spending in 2013." In addition, GDP growth in 2012 rose to pre-Arab Spring levels.

The data on increased PE investment activity coupled with the overall upbeat business and economic outlook are positive indicators of the industry's recovery. But is new capital staying on the sidelines due to the Arab Spring?

Fundraising: Temporary or Permanent Impact?

In the MENA region, fundraising declined from just over $4 billion in 2007 to $1.2 billion in 2009, according to a report from Private Equity International. Since then the amount of capital raised for funds targeting the region has remained under $1 billion. In 2012, funds targeting the region had extreme difficulty raising enough to meet their capital targets.

Meanwhile, a private equity report by Grant Thornton found that only a small minority of MENA general partners (GPs) felt positive about raising new funds in 2012. Many investors pointed to a divided market where top-performing managers raised funds with relative ease, while the rest struggled. However, this is better than in the BRIC countries and in the Asia-Pacific region, where even more respondents thought it was challenging to raise new funds.

The contraction in the number of GPs active in the region has also contributed toward the decrease in capital raised, with a high number of firms not being able to survive due to harsh conditions. A large number of GPs also focused their efforts away from fundraising, instead working to ensure the success of their portfolio companies despite the difficult financial climate.

According to Deloitte's 2012 MENA survey, two-thirds of respondents believed that the global limited partner (LP) appetite for the MENA area will remain at the same subdued levels due to continuing market instability and an uncertain political environment. There is a belief that the media exaggerates the regional uncertainty, keeping global investors at bay indefinitely.

By 2012, there were promising signs of a recovery despite the ongoing turmoil. Investors are increasingly looking at Egypt, Tunisia and Saudi Arabia as attractive hubs for investment. The smaller number of private equity firms in the region has also led to more favorable conditions because of lower competition for LP capital. There has also been a positive shift in the balance between capital raised and investment opportunities.

There are hopes that the Arab Spring could lead to positive changes in the way the industry operates. Investors anticipate the aftermath of the political unrest will bring greater transparency in deals and allow more investment opportunities to open up.

Concerns Remain

Despite this positive news, the consensus is that LPs are not confident that investments in the MENA region will be profitable. Political and economic risks are among the main factors LPs consider when deciding to invest in a MENA-focused fund. In an area heavily affected by political unrest, it is important for LPs to be able to rely on fund managers to have an excellent understanding of the investment landscape.

When asked about their investment appetite following the Arab Spring, one recent survey found the majority of LPs (58%) and GPs (85%) said they intend to keep their investments in the region unchanged as part of a longer-term strategy. Of those who responded that the Arab Spring would affect their investment in the region, LPs are more cautious towards investment in MENA, with 12.5% of respondents considering decreasing their allocation to the region. Meanwhile, no GPs indicated that they wish to do the same. However, a larger percentage of LPs than GPs are considering increasing their investment or newly investing in the MENA region, with over 29% of LPs responding positively as opposed to only 15% of surveyed GPs.

Simultaneously, some LPs remain concerned about financial stability following the Arab Spring and are increasingly demanding a "soft commitment" option that allows them to veto individual investments. It's too early to tell what the lasting impacts of the Arab Spring will be, but these short-term consequences are certainly being felt in private equity markets. Over half of surveyed GPs felt that the short-term implications for fundraising were negative for launching new funds, fundraising for existing funds and reaching a final close. However, several GPs feel that there will eventually be a positive impact on investing in portfolio companies, earnings of portfolio companies and exit opportunities. This is mostly due to lower valuations and new sectors being opened up to private investors

The Future of MENA Fundraising

Changing Power Dynamics: The changes in the MENA region have contributed to shifting the power dynamic from GPs to LPs. LPs have increased their demands in the fundraising process and asked for more transparency, due diligence and lower management fees. This trend will likely continue into the near future as fundraising conditions remain challenging. Additionally, the increased LP demands will have another side effect — increasing the gap between winning and losing funds by exacerbating the already limited back-office resources of underperforming funds.

Sources of Capital: According to the Grant Thornton "Global Private Equity Report 2012," roughly one third of the LPs who invested in MENA funds are domestic. Domestic investors have been the most active since they have critical local expertise and contacts. LPs outside of MENA will remain cautious about placing capital in the region due to several factors, including perceived political instability, attractive opportunities in other emerging markets and a lack of performance history from local fund managers. According to Deloitte's MENA "Private Equity Confidence Survey 2012," many experts believe that it could be 2014 before international LPs become comfortable with investing in MENA. Given all of these factors, a significant portion of capital is likely to continue to be sourced domestically.

LPs in the region are heavily weighted toward family offices since a single family can oftentimes be a dominant investor in the region. Given distributions of wealth in the region, this trend is likely to continue. Almost half of all respondents to the Deloitte survey estimate that family offices will be the most active investors over the next year.

The Rise of Sovereign Wealth Funds: The region will also likely see a rise in activity from sovereign wealth funds (SWFs), according to a paper by Private Equity International. These SWFs are increasingly looking to deploy capital to alternative assets with higher returns, and private equity is an ideal candidate. Global SWFs are also growing their assets quickly: In 2012, SWFs around the world had $4.62 trillion of assets under management, a 16% increase from 2011, according to a report from Financier Worldwide. Consulting firm Bain & Co. estimates that over the next few years, the 10 largest SWFs with private equity exposure will inject up to $60 million in the asset class. The increased interest in private equity from the largest SWFs could encourage smaller SWFs to follow suit.

Meanwhile, the majority of SWFs that invest in private equity are based in Asia and MENA, which could bode well for private equity in the MENA region since investors may be more confident to invest in their own backyards. It doesn't hurt that MENA SWFs tend to receive steady streams of capital from oil resources and have relatively long investment time horizons.

"SWFs enjoy enormous flexibility as PE investors," said Bain in its 2012 global private equity report. "Unlike conventional LPs, which try to match the duration of assets and liabilities in order to meet their need for liquidity, SWFs can patiently commit capital over long time horizons."

Managing Regional Risk

Some recent global trends suggest investors are increasingly trying to mitigate the risk of local investments. First, it seems SWFs with private equity exposure are focusing more on investing in multi-manager vehicles. In 2012, a report in Financier Worldwide showed nearly one-third of SWFs said they preferred investing in PE equity funds-of-funds, up from 20% in 2011. Clearly, SWFs are hoping to minimize their risk by diversifying. Second, PE investors in MENA are beginning to prefer investing on a deal-by-deal basis rather than invest in blind pools of funds, according to Deloitte. Global investors also seem to have more stringent investment criteria, which could serve to increase transparency and decrease risk over time.

Conclusion

Unsurprisingly, the Arab Spring's short-term impact on PE was negative. Both investing and fundraising activity fizzled out as the MENA region experienced unprecedented levels of unrest. But this reduced activity was followed by cautious optimism from those who were knowledgeable about the region.

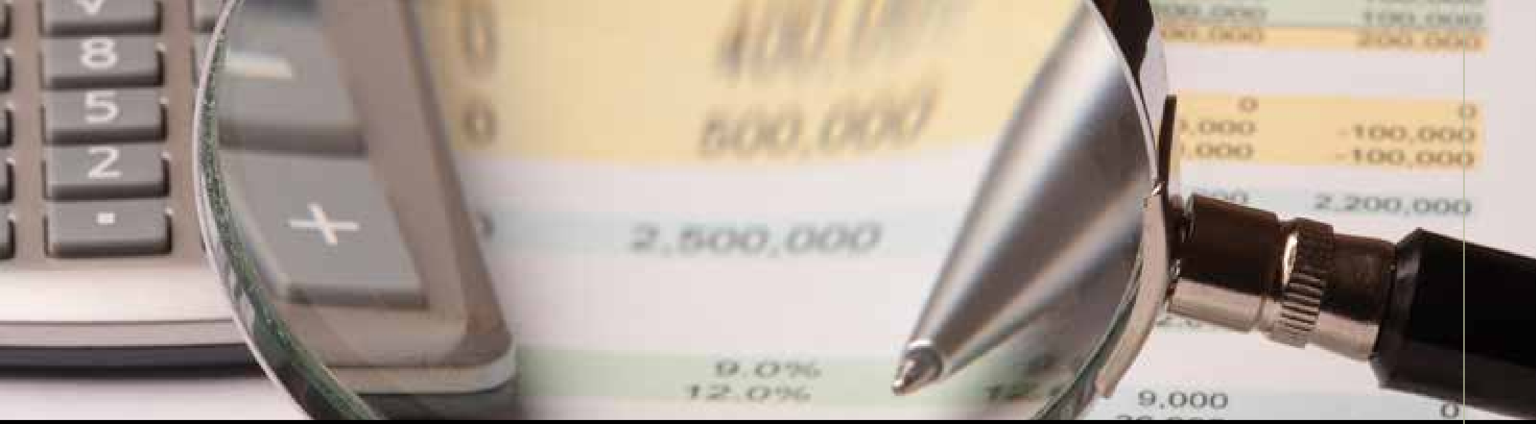
Unrest has paved the way for reform and, in the process, a large region is now slowly being opened up for PE investment. The industry is already seeing signs of recovery from the 2009 and 2010 doldrums, and significant government and foreign funding, coupled with consumer markets that are poised to grow, set the stage for resurgence in private equity investments.

But the benefactors of this resurgence are unlikely to be outsiders and international PE leaders. Foreigners are more likely to view the Arab Spring as a cataclysmic event and less as an investment opportunity. Instead, insiders and domestic professionals could be the main beneficiaries.

PE players that already have a significant presence and experience in the MENA region will be best poised to benefit from any recovery. Meanwhile, fundraising is still at low levels, meaning that only firms with adequate "dry powder" can take advantage of the lack of competition and depressed asset valuations.

Thus, PE players who are in the know will disproportionally benefit from the Arab Spring as they leverage existing knowledge and funding resources to capitalize on what may be an unparalleled investment opportunity in the region.

This article was co-written by Mila Adamove, Rehi Alaganar, Alia Avidan, Jagan Pisharath and Terry Wang — members of the Wharton MBA Class of 2013.



Very Public New Regulations for a Very Private Industry

For many years, private equity (PE) relied on light-touch regulation and self-governance, which kept the industry out of the limelight. Those halcyon days now seem to be over.

The passage of a wave of new regulations has opened the door for a new era of post-crisis scrutiny on the once-opaque PE industry. The net effect has placed PE more in the spotlight, in the same way that hedge funds and the big Wall Street banks have garnered more attention.

Demands for enhanced transparency have grown louder over time, bolstered by the media blitz of the last election cycle, increasing allocations from public pension funds and Main Street's growing exposure to PE via financial sponsor IPOs.

A look back at developments over the last few years sheds some light on this new world of scrutiny and provides more information about the efficacy, efficiency and continuing evolution of regulatory actions.

Transformative Rules and Regulations

PE's protective shell first began to wear thin in September 2006, when the U.S. Financial Accounting Standards Board adopted the Statement of Financial Accounting Standards No. 157 (SFAS 157), which clarified the meaning of fair value in generally accepted accounting principles (GAAP) as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement data."

This was a huge change: It directed PE firms to mark-to-market their portfolio holdings instead of holding them at cost. The mechanisms around fair valuation were further outlined in May 2011 with Accounting Standards Update 2011-04, which sought to increase transparency by requiring funds to provide detailed disclosures of the estimates, assumptions and supporting documentation used in all fair value models.

In what now looks like a clear foreshadowing of future actions, the Securities and Exchange Commission (SEC) announced in August 2009 the eventual reorganization of its Division of Enforcement into five specialized units designed to enhance the its ability to protect investors. The largest of the newly specialized units, the Asset Management Unit (AMU), focuses on investment advisers and companies, including PE funds. The AMU is staffed with 75 full-time employees, including PE industry experts, and uses advanced risk analytics to detect problematic fund conduct.

The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law in July 2010, brought sweeping changes across many areas of the financial services landscape, including PE. Dodd-Frank eliminated the private adviser exemption, requiring most PE firms to register with the SEC by March 2012. Dodd-Frank also included the Volcker Rule, which limited banking entities to owning no more than 3% total interest in alternative asset funds, in addition to limiting their investment in alternative asset classes to no more than 3% of the bank's Tier 1 capital.

The full force of these regulatory actions was revealed in September 2011, the first complete fiscal year under the SEC's finalized restructured enforcement program, when the agency filed a record 146 enforcement actions against investment advisers, a 30% increase over the prior year and a 92% increase over 2009. This marked the beginning of the end for PE's private persona.

Taking to the National Stage

With Mitt Romney's ascension in late 2011 as a leading candidate for the Republican nomination for President, his background as chief of Bain Capital served as a lightning rod of criticism against the PE industry from both Democrats and competing Republicans. The popular critiques portraying PE managers as tax-avoiding corporate raiders who profit via massive lay-offs, cost cutting, and over-leveraging, gained widespread media attention for the first time.

In December 2011, as media attention on Romney's candidacy intensified, the SEC's enforcement unit sent letters to several leading PE firms as part of an informal inquiry into the industry. The SEC's stated goal was to investigate possible violations of federal securities laws as well as to deepen the commission's understanding of myriad issues related to the industry, including how PE firms value investments, impose fees and allocate costs.

The enforcement unit had been heavily criticized in the past for its ineffectiveness in regulating the financial services industry in the period leading to the worldwide economic downturn, and has since taken a more aggressive, public stance in its vow to eradicate corruption and impropriety on Wall Street.

The AMU's co-chief, Robert Kaplan, explicitly put the PE industry on notice at a conference in January 2012 when he said that "Private equity law enforcement today is where hedge fund law enforcement was five or six years ago." This was a warning for the industry to expect increased attention and enforcement going forward.

Armed with a clear focus, the requisite manpower and powerful new analytical tools, Kaplan and the AMU set upon a mission to police the previously self-regulated industry. The AMU used the Aberrational Performance Inquiry (API), a proprietary risk analytics engine, to highlight areas for further review. The API helped analyze funds' investment strategies and other benchmarks to evaluate returns and highlight inconsistent performance. By December 2011, the API had already been credited with six enforcement cases.

In the months that followed, more inquiries and enforcement actions would take place pertaining to a host of private equity activities, including overstatement of portfolio fair value, insider trading, cherry picking, price collusion, misallocation of transaction and portfolio expenses and misstatements made to limited partners.

In October 2012, the SEC announced that newly registered private fund advisers would have to conduct a series of "presence exams" administered through the commission's National Exam Program. According to the SEC, the exams would review certain high-risk areas. Focus areas included valuation, marketing, security of client assets and portfolio management. Any serious deficiencies would result in an examination summary letter and potential action by the Division of Enforcement.

It does not take a massive leap of faith to believe that the recent increase in the carried interest tax rate was facilitated by this new era of PE scrutiny. Carried interest is the share in profits that PE managers take as compensation when their investments perform well, and is classified as a long-term capital gain, which is taxed at a significantly lower rate than the ordinary income tax rate. In the recent budget deal, lawmakers increased the top rate on long-term capital gains from 15% to 20%. It is still very possible that capital gains may eventually be taxed as ordinary income. According to the Joint Committee on Taxation, such a rate change would result in additional government income of $16.8 billion over 10 years.

What's Next for the Industry?

It does not seem that the tide of media attention, regulatory scrutiny, and public speculation directed at PE will abate anytime soon. This sentiment was affirmed by AMU co-chief Bruce Karpati, who in January 2013 at the Private Equity International Conference said, "It's not unreasonable to think that the number of cases involving private equity will increase."

A near-term focus for the AMU will be identifying "zombie managers," defined as fund managers who have been unable to raise follow-on investments. The SEC's thesis is that while most "zombie managers" will continue to act in the best interest of their investors, there will be others who will be incentivized to shift priorities and focus far too much on maximizing their own revenue to the detriment of others, leading to problematic conduct and possible regulatory violations.

This "new normal" of increased regulatory oversight and media scrutiny will lead many PE managers to wonder how to conduct themselves and their businesses in the future.

Robert Rapp, a partner at the law firm Calfee, Halter & Griswold LLP, explains that, "going forward, it will be up to private equity managers to look through the lens of fiduciary duty to understand expectations, identify and resolve conflicts of interest, and know what drives enforcement."

PE firms must strive to have well-documented, consistent, and transparent policies and procedures, while bracing themselves for the tangled web of uncertainty, disagreement and frustration that comes with an evolving regulatory landscape.

This article was written by John Daly, a member of the Wharton MBA Class of 2013.

Investing in Times of Distress: The Bank of Ireland and WL Ross

The credit and sovereign debt crises of the past few years continue to profoundly reshape the financial landscape across the developed world. One of the most visible consequences from this difficult era has been the incessant restructuring of major European financial institutions. With low investor risk tolerance, capital-starved governments, and European banks facing the twin headwinds of ongoing economic weakness and more stringent regulation and capitalization requirements, compelling opportunities for well-positioned private equity (PE) investors look likely to remain abundant.

In July 2011, a group of investors, led by turnaround specialist WL Ross & Co., recognized this opportunity and announced they would purchase roughly 35% of Ireland's largest bank, the Bank of Ireland (BOI). The price tag for the transaction was $1.45 billion (€1.1 billion), representing a post-money valuation of roughly 0.33 x price divided by the tangible book value (TBV – which equals a corporation's total book value minus the value of intangible assets, including brand value, intellectual property, patents, goodwill and the like). Over a year later, BOI traded at roughly 0.50 x price divided by TBV, generating a 30% annualized return. Below are some of the critical lessons PE investors might consider in their ongoing survey of distressed banking opportunities across the continent.

Background

In the wake of the 2008 global financial crisis, Ireland experienced a near collapse of its financial system, largely driven by a rapid, fundamental deterioration in the country's largest banking institutions. The situation became increasingly dire following the country's 2008 decision to guarantee all bank deposits and nearly all liabilities (including forms of unsecured, subordinated debt). In the years following the Irish government's guarantees, the inextricable relationship between the sovereign and its main banks only intensified.

While all of Ireland's principal banks suffered from similar exposures, fundamental deterioration, lax regulations and flawed strategies, only the BOI received substantial non-state equity capital. More generally, the Irish banking crisis featured many of the same issues afflicting banks of other developed countries. However, unlike the banking issues within the United States and other EU nations, the Irish crisis was almost entirely related to property speculation and the explosive domestic housing bubble of the preceding 10 years.

During this period, a race to the bottom to gain market share among growing developers and builders ensued among Ireland's largest banks. As a result:

- Property-related lending accounted for 80% of credit growth among Ireland's principal financial institutions. This growth bolstered government coffers with significant, albeit unsustainable, revenues. Tax cuts and other reforms correspondingly followed, leaving the Irish government with little to no room to support the economy (and, by extension, its ailing banks) outside of significant policy tightening in the face of falling output and rising unemployment.
- Fundamental deterioration among the most aggressive lending institutions led to a crisis of confidence among more viable lenders. That made an issue that might have otherwise been contained to one or two large banks endemic to all.

- As property lending expanded, the quality of the loans deteriorated, exposing the Irish banks to serious stress when underlying property exposures deteriorated.

Bank of Ireland, Restructurings and Implications for Investors

Founded in 1783, BOI derives a majority of its business from mortgage lending in Ireland and through other financial services throughout the United Kingdom, including business banking and deposit gathering. Within Ireland, BOI holds either the first- or second-largest market share across most key products, such as residential mortgages, personal accounts and credit cards. Going into the crisis, BOI's strategy and balance sheet reflected many of the problematic symptoms endemic to large lenders afflicted by unprecedented liquidity followed by rapidly deteriorating fundamental conditions:

- **Loan and asset growth.** From an already substantial basis of €80 billion in 2005, net loans still managed to grow at an astounding rate of nearly 20% over the next three years.
- **Extensive and expensive leverage.** Return on Average Assets (ROAAs) was tiny compared to Return on Average Tangible Common Equity (ROATCE), which was very high prior to 2007. Meanwhile, net interest margins – at less than 2% over the past eight years — suggested extensive use of leverage relative to fundamental cash flow generation.
- **Rapid escalation in impaired, delinquent, charged-off loans (particularly among Irish and UK-based property and construction borrowers).** Between 2004 and 2009, every absolute and relative measure of the BOI's distressed assets escalated materially, particularly among property and construction borrowers, which represented a disproportionate 58% of total loan loss provisions compared to only 26% of gross loan exposures.

Fundamental strains to the system continued to compound within Ireland's banking system and, in the wake of Lehman Brothers' collapse, liquidity and solvency contracted among credit providers globally. The prospects of an outright credit system collapse within Ireland escalated rapidly. In response, a series of bailouts, reforms and restructurings unfolded over the next three years, thereby laying the groundwork for the WL Ross transaction. The following points highlight the most salient lessons for PE investors who are considering similar situations:

Uncertainty as an ally: Fundamentals-oriented investors think that the market's perception of uncertainty can create significant gaps between intrinsic and realizable value. Today's landscape for eurozone banks contains seemingly endless uncertainty, which, depending on market sentiment, can stretch that value gap beyond what facts should justify. In Ireland's case, market rumors regarding haircuts (a reduction to less than full repayment) for senior bondholders of liquidating banks increasingly plagued BOI's securities throughout 2011, throwing the proverbial baby out with the bathwater.

But any investor with access to Google might have seen that not only was BOI more favorably capitalized, provisioned and asset-healthy than its liquidating peers, but also that Ireland's government had explicitly stated haircuts for BOI were "off the table." That made the Bank's then valuation of 0.1 times the price, divided by the tangible book value, a relative bargain. In today's intensely uncertain eurozone banking environment, many investors will likely take a "fact agnostic" approach to selling at even the slightest hint of concern. For the diligent investor, such selling could provide the ripest investment opportunities.

'Pretty pigs' and 'sacred cows': Most eurozone banks today remain in varying degrees of distress. While stock prices have rallied over the past year, significant risks remain to the downside, many analysts agree. With this in mind, investors must be sure they have a high level of confidence in their management and their strategy to deal with deeply distressed scenarios. So-called "clean balance sheet bargains" will likely prove rare. Despite this distress, some banks will be stronger and better positioned ("pretty pigs"), and more systemically important for their given economy ("sacred cows").

For Ireland, BOI was both and, in March 2011, the government announced its explicit intention to rebuild the banking system around BOI and its next largest competitor. Ireland would seek to ensure BOI's survival. Despite this, the bank's shares still traded at levels implying "non-survival," allowing WL Ross to get a deal. Investors should seek to understand the timing and magnitude of the prospective capital needs of those institutions that have the right blend of "sacred cow" and "pretty pig." Investing when those needs for support become most dire should minimize downside loss potential.

Charging for confidence: Market confidence (or lack thereof) can translate to life or death for banks in struggling eurozone countries. The more a bank can do to regain that confidence, the less the government will have to commit in order to keep it solvent. The Irish government, which prior to the WL Ross investment held approximately 36% of the bank, did not need to raise capital with this group of investors.

But in doing so, Ireland reduced its politically sensitive exposure to the bank and signaled to the world that brand name institutional capital was willing to invest. This was a critical market-based validation. Ireland was wildly incentivized to obtain such validation — the sooner BOI could graduate from taxpayer to institutional capital, the sooner its government could begin positioning other nationalized banks to do the same.

As such, these investors were able to "charge" Ireland for that validation in the form of a remarkably cheap valuation. Potential investors in eurozone banks today also could seek to leverage the prospects of early market validation and the benefits it would bring in exchange for in terms of valuations.

Today, BOI continues to thrive, having recently completed a significantly oversubscribed issuance of contingent convertible bonds, providing further evidence of the market's faith in the bank and its recovery prospects. This, in turn, has continued to benefit WL Ross and in part validates the lessons described here. These lessons, however, provide only a subsection of the PE playbook for eurozone banks. Examinations of other failures and restructurings should prove instructive as investors continue to navigate the inherent complexities — and opportunities — presented by European banks.

This article was written by Victor Dupont, a member of the Wharton MBA Class of 2013.

How Do Private Equity Firms Create Value?

In the Hollywood version of a hostile takeover, the boss would grab control of a company, throw out the slackers, move into the corner office and start barking out orders. The message is, "it's my way or the highway!"

But what makes for good drama on the screen doesn't necessarily work in real life. When a private equity (PE) firm buys a portfolio company, it's much more like a romance instead of a war movie. For the new partnership to work, both parties must really believe they will be better off together instead of alone.

A successful PE investment is the result of careful research before the purchase, smooth relations with the firm afterward, creation of a clear plan focused on just a few priorities, and disciplined execution. This model for PE success was relayed by five PE executives who spoke on a value creation panel at the 2013 Wharton Private Equity & Venture Capital Conference.

While the strategies for managing each portfolio company can vary widely, the panelists agreed on a key feature that leads to success: Instead of micromanaging, PE owners must furnish the company with a top-quality CEO (ideally for the duration of the investment) and provide the leader with advice and support along the way.

Picking the Best Fruit

A critical element of success comes at the earliest stages — before the investment has even closed — with the careful selection of the portfolio firm, said Bill Fry, managing director of American Securities.

Most PE executives agree that the ideal target is not a train wreck but a firm with just a few areas that need improvement. Sometimes a firm has grown too big and complex for the founder to manage alone. The company may need financing, help in streamlining systems and operations, or advice on which products or services to develop next. But at its heart, the ideal target firm is sound. Typically, the PE firm seeks to target a good core business "that maybe has lost [its] way," said Ashley Abdo, managing director of M&A at The Gores Group.

When a target firm starts offering itself to PE partners, it may produce a list of 12 ways to grow and improve performance, said Fry. Sometimes the target's investment bankers push the firm to produce a long list, thinking multiple options for enhancing performance make the analysis look more thorough and make the deal appear more promising.

"Over time, as the company is pitching it, they come to believe all 12 of those things," Fry said.

But in truth, the company may only have three or four areas that present real opportunities. A PE firm needs to separate this wheat from the chaff during the due-diligence process that precedes the decision to buy, he noted. Then it needs to get the target's management to focus on "what they really believe in versus what they are selling," he explained.

"The flip side of that is, if there are 12 things [that need improvement], you probably don't do the deal," added Abdo. Moreover, the target firm must not present too much risk of loss, he continued. If there is not enough "downside protection, we don't even talk about the upside." Capital protection is the name of the game, said Abdo.

Provided due diligence and preparation are completed before the sale is closed, the PE firm does not have to waste time afterward figuring out the next move. "We're looking at places where we can immediately accelerate growth," said Tom Shaffer, director at Alvarez & Marsal.

CEO Cooperation and Cohesion

Whether the target company's CEO came with the purchase or was installed by the PE owners, the panelists agreed that this leader must be an eager supporter of the new owner's strategy. Several said they used a 100-day plan that starts on the day the deal is closed. This plan does not leave time to bring a resistant CEO around, though executives with qualms do often see the benefits of the PE relationship once the strategy becomes clear.

"Once the CEO comes over and says, 'Okay, these [PE] people are smart people and they can help me,' we usually do pretty well," Fry said.

For instance, the CEO may be a founder whose firm has grown too big to handle alone. If the PE partner has a clear strategy, "you'll literally see the CEO relax in his chair and say, 'thank God there's someone coming in to help,'" said Shaffer.

The experts provided by the PE firm are not there to tell the CEO what to do day-by-day, but to flesh out the CEO's staff, said Abdo. Thus, added Shaffer, the PE firm tries to avoid a "combative model" and instead works to provide reassurance that the CEO and PE experts are on the same page and working together. It's important to "allay those concerns," he said.

"I would add that it's all about alignment," said Seth Brody, operating partner at Apax Partners. The CEO and the PE management team must share a vision, and managers of the portfolio firm must be replaced if they don't share the PE owner's views, he argued.

Aligning Interests on the Inside and Outside

The panel's moderator, Geraldine Sinatra, a partner at Dechert LLP, a law firm that advises various players in the PE arena, asked how the PE firm makes sure the acquisition's management is on board with the strategic plan.

At American Securities, this process often begins with a breakfast the morning after the sale closes, since legalities and other issues can limit contact before the deal is complete, said Fry. A series of meetings, and then a retreat a couple of weeks into the partnership can help ease the worry and clear away the sense of mystery, he said.

Some PE firms conduct large meetings that include the acquisition's managers, customers, vendors and suppliers, noted the panelists. These gatherings make each player better aware of the other's concerns and allow individuals to have more face-time with one another.

Another technique to ensure goals are aligned is to bring together the CEOs of all the PE firm's portfolio companies once a year, said Abdo. "It's a very powerful couple of days," he said, "part catharsis, part networking." Often, the CEOs find they are facing similar challenges. Sharing their concerns with one another leaves them feeling less isolated and more connected, said Abdo.

PE firms also typically put their own people on the acquisition's board to ensure the new strategic plans are being executed. The people installed on the boards could either be PE executives or outsiders with useful expertise. American Securities usually puts two outside directors on the board of each portfolio firm but ensures these senior people operate with a style that's "non-threatening to the CEO," said Fry.

In addition, it's important to link compensation for the firm's senior managers to their success in implementing the PE firm's detailed strategic plan, said Abdo. That can be very critical in ensuring goals are aligned.

CEO Stability

Another key to value creation is stability in the corner office, according to Fry. "We start and finish with the same CEO about 80% of the time," he said.

Meanwhile, The Gores Group has often used its most successful CEOs on subsequent acquisitions. "We like to have relationships where they want to come back and do another deal with us," said Abdo.

Despite all these efforts, things don't always work out. The PE firm must move quickly when projects start going off the tracks, Abdo noted. He recalled a case where The Gores Group bought a Belgian company that was in financial trouble. Gores installed a growth-oriented CEO, but the overleveraged firm also needed to cut costs. After some cuts were implemented, the CEO felt that more cuts would wreck the business, but Gores feared the firm would go bankrupt if it didn't continue to trim. Eventually, the CEO had to be replaced.

"If you've got that misalignment, you can't just continue to operate," he explained. "One of you is right, and one of you has to go."

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Venture Capital: The Art of Picking the Few from the Many

Venture capital (VC) has never been a mega-industry, but many who work in the sector seem happy with the current state of affairs.

VC funds raised $20.6 billion in 2012, Thomson Reuters reported, but this amount is dwarfed by the $311 billion that was raised by the private equity industry, including venture capital, in 2012, according to research firm Prequin.

The sector has also had some recent ups and downs in terms of fundraising. The latest figures show that the VC industry has shrunk since raising $25.6 billion in 2008, but is recovering from the depths of the financial crisis in 2010 when fundraising fell shy of $14 billion.

When it comes to looking ahead to the future of the VC industry, speakers on the venture capital panel at Wharton's 2013 Private Equity & Venture Capital Conference were optimistic about producing strong returns for their investors despite a "new normal" that may leave the industry with less money to work with for the foreseeable future.

"In some ways, [our relatively small size as an industry is] a good thing, because venture capital as an asset class is hard to scale," said Imtiaz Kahn, principal portfolio manager for pension and endowments at The World Bank. As an investor looking for promising VC funds, Kahn realizes that the business of investing in young companies is inherently difficult and risky. The key to success is taking care in picking the few really good opportunities from the many, he noted, and remembering that there are always some stars whether the market is growing or shrinking.

Since venture capital is so inherently risky, it is hard to generate consistent returns over the long term, which keeps investors from pouring assets into the sector, Kahn said. "It's difficult. You want to go with the best-returning funds, and those are limited.... The bar is really high for adding a new fund to our portfolio. We haven't added a new venture capital firm in a few years."

Limited funding for the industry does have its benefits, added Michael F. Bigham, a partner at Abingworth, a VC firm with offices in London, Menlo Park, Calif., and Boston that specializes in life sciences and health care. There are still plenty of young firms to invest in and prices are good, he said, and if too much money were to flow into the industry, prices might increase to the point where it is difficult to make profitable investments. Over the long term, conservative funding will be "very healthy" for the industry, Bigham noted, predicting good returns over the next five years.

The VC Funding Evolution

Funding for the VC sector has evolved in recent years, leaving what some describe as a barbell-shaped industry – a few very large funds, a lot of very small ones and little in between. "There is a paucity of $100 million to $500 million funds," said Matt Harris, managing director of Bain Capital Ventures, the venture operation at Bain Capital. Only a few years ago, most funds fell into this mid-sized category, he added.

The recent trend toward very big and very small funds has occurred because limited partners have been attracted to the high-performing funds, which has helped them grow even larger, while others have moved to small funds that operate in niches that are too modest to soak up money, explained Harris.

Large investors, such as pension funds, gravitate to the big VC operations because it is too difficult for these investors to perform due diligence on a large number of small funds, Kahn added. Meanwhile, the very small funds are big enough to serve the needs of wealthy individuals and families, he said.

New Opportunities

While money is tighter than it once was, panelists at the Wharton conference agreed that investment opportunities abound.

"All the Wall Street guys who used to brag about the cool restaurants they were invested in are now bragging about the tech companies they are invested in," joked panel moderator Brett Topche, managing director of MentorTech Ventures, a seed- and early-stage venture capital fund that invests in companies that emerge from the University of Pennsylvania.

New companies in need of VC support are springing up at a rapid clip, said Harris. "Many of our young people are deciding to be entrepreneurs," he noted. "It's a wonderful thing."

This rise in entrepreneurship is due to the fact that it is now fairly easy and inexpensive to start a software company, explained Adam Enbar, a team leader at Charles River Ventures, a Boston and Menlo Park, Calif.-based VC firm focusing on technology and new media. Many tech start-ups, for instance, are developing applications for smartphones and tablet computers, he said.

This environment can be challenging for a VC fund trying to separate the good opportunities from the bad. Some start-ups are jumping on the bandwagon, trying to cash in on an idea that has already been successfully developed by another firm, Kahn noted. "I think that's sometimes concerning," he admitted.

While Harris agreed that there are many "me too" ideas in the market, he cautioned investors against immediately writing off a young firm with an unoriginal idea. Original ideas can begin to surface once a company starts making progress, he said. "One thing we know about entrepreneurs is that where you start is sometimes very different from where you end," he noted.

VC funds can also find opportunities in markets that don't have a lot of "pizzazz," Harris pointed out. For example, over the last decade Harris has been working with firms that are developing alternative payment systems, such as variations of PayPal for retailers, which provide easier business-to-business transactions. He has also been looking at ways to use new types of data to underwrite consumer and business lending. "I do a lot of payment stuff. I think there are many more chapters to that book," he said.

The panelists also discussed the rise of New York City as a tech center that is challenging Silicon Valley. "You don't have to be in Silicon Valley anymore," Enbar noted.

Twenty years ago, a tech start-up would have had a tough time hiring engineers and finding capital if it was not in Silicon Valley, Enbar added. But in recent years, start-ups have begun to think more about where their customers are located. "If you're thinking about where your customers are, more often than not they're in New York."

A Word of Advice for Young Entrepreneurs

Topche asked what advice the panelists would give to young people interested in starting companies, or in joining start-ups.

"Find a company that's exploding," said Enbar, observing that it is fairly easy to start a business but difficult to make one grow. Though the idea of joining a firm with only five employees may seem appealing, "more likely than not you're just going to learn how a company fails," he noted.

Young entrepreneurs should also think about their firm's long-term prospects, Enbar added. "Don't work on problems that are difficult and unimportant," he said. "If you're going to do something, make sure you're solving a problem that will keep you going beyond the [VC backer's] exit."

Harris said that when he thinks about whether to back a young firm, he looks for what drives the entrepreneur, favoring ambition that originates with "a life lesson, not a whiteboard." He prefers individuals who are focused on an idea, not just on getting rich.

"In the absence of an authentic impulse to go build something, don't build something," he advised. Instead, "join a company that's already building something."


Having lots of dots on the map doesn't mean anything if they're not connected.
In today's world, where you are should never get in the way of where you need to be. We have the right people, wherever you need them. Find out how our global approach can help you at ey.com/privateequity.
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2013 Wharton Private Equity Review:

Navigating the 'New Normal'

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