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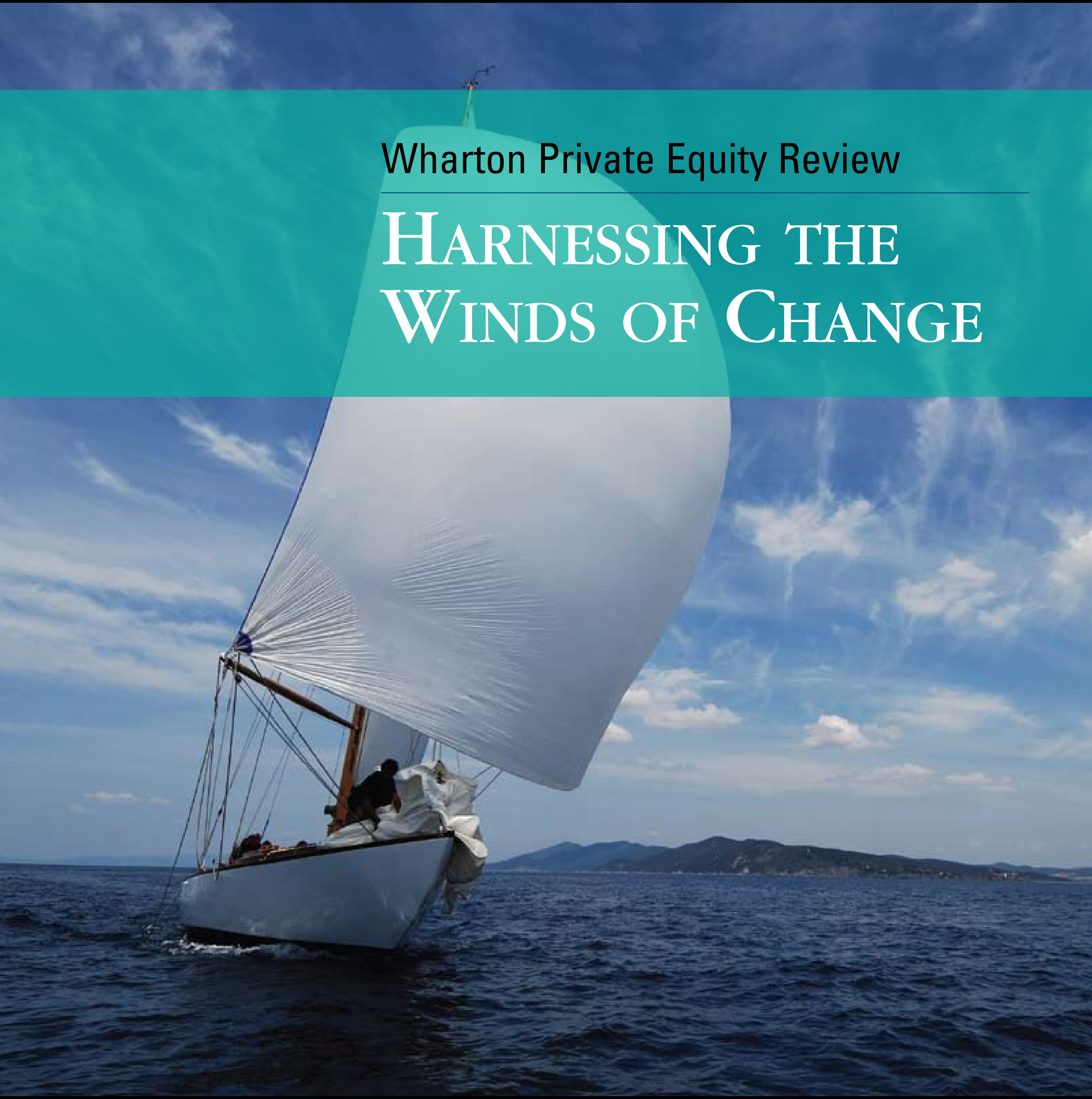
Wharton Private Equity Review

Harnessing the Winds of Change



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Following the Era of Large Buyouts, Private Equity Funds Find New Ways to Compete

Nothing symbolized the most recent private equity boom better than huge buyouts, deals so big that private equity sponsors teamed up to pull off the transactions in so-called consortium — or "club" — deals that spurred talk of $100 billion transactions.

Now that credit has dried up, the future of large private equity buyouts has become uncertain. Limited by the lack of available debt financing, buyout firms are looking to compete in middle-market and foreign deals and, in many cases, are teaming up with strategic buyers and corporations in new types of transactions. Not surprisingly, the economic downturn has also paved the way for a resurgence in distressed investing, as lenders and investors alike begin to adjust to new pricing realities.

One major difference in the most recent cycle was the amount of capital raised.

According to Jack Daly, a managing director at Goldman Sachs focusing on large-cap leveraged buyouts in the U.S. industrial sector, 2007 was a "tale of two markets." In the first half of the year, private equity sponsors enjoyed easy access to debt which led to previously unthinkable discussions about deals valued at up to $100 billion. By the end of the year, credit markets had contracted and the industry faced a $350 billion overhang. Lenders were unable to provide large financings and included extensive covenants on the loans they did write. "The next $10 billion deal feels years away," Daly said.

The only constant was sellers' high expectations about the value of their businesses, noted Daly, who participated in a panel discussion about large buyouts at the 2008 Wharton Private Equity Conference. In the face of the current economic turmoil, however, those expectations have begun to drop. The buyout business is cyclical, he added, noting other industry boom-and-bust periods — in the late 1980s, the late 1990s and again from 2002 through the end of 2007. The public markets experience the same ups and downs, he said.

The latest boom came to an end in the usual way. "What happened was that people got out of hand with some of the valuations," he said. Add to that the subprime meltdown and it signaled the end of the industry's ability to digest deals like Blackstone Group's record $36 billion acquisition in 2006 of Equity Office, the Chicago-based commercial real estate investment trust.

One major difference in the most recent cycle was the amount of capital raised, Daly noted. The industry has raised about $750 billion since January 2006 — an amount which, when levered, would be enough to finance deals worth a significant portion (15%-25%) of the Standard & Poor's 500. Buyout firms have remained relatively flush. "There's still a staggering amount of money sitting there," said Daly, who added that companies will find new ways to make deals work even if there is less debt financing available from lenders. "There is a tremendous amount of opportunity. There are still going to be a lot of ways to make that capital work."

A Return to Fundamentals

According to Perry Golkin, a partner at Kohlberg Kravis Roberts and a member of the firm's financial services industry team, the markets are clearly not deep enough to support huge private equity deals. Instead, sponsors should focus on smaller transactions, he said. PricewaterhouseCoopers research shows that the volume of large buyouts fell off sharply in the second half of 2007, but that middle-market deals, valued at up to $1 billion, totaled $355 billion, or 23% of U.S. transaction volume.

Lenders are demanding changes in covenants, Golkin said, which represents a return to more normal conditions after the boom period marked by easy loan terms. The revised covenants do not represent "radical change" but do restrict private equity firms' flexibility, he added. "We had some luxury for a little time, but the reality is we will not have the flexibility we were able to negotiate for the last couple of years."

According to Golkin, rising capital costs will reduce asset prices, and the diminished role of securitized debt funds will also affect private equity sponsors. "All of these things are going to make it a little more difficult for a buyer, or sponsor, to structure a deal in a way that's comfortable. You become more nervous." The industry will return to fundamentals that prevailed three or four years ago, he added. "We're not moving to the Stone Age."

The largest limiting factor now is that sellers' expectations have not caught up with the new pricing realities. Golkin noted that as deals collapse in the changing financial environment, the industry is wrestling with the question of what represents a material change in a business that might trigger a breakup fee. For example, is a 10% drop in earnings a material development? The Delaware court system is examining some of these issues, he said.

Other questions surround the value of a reverse breakup fee, which takes effect when a buyer walks away from an agreement before it is completed. Private equity sponsors will need to look at the structure of transactions to decide whether the breakup fee will cover the costs of terminating a deal. "I don't think when [breakup fees] were created, people would have predicted that financial markets would disappear," he said.

Greg Mondre, managing director of Silver Lake, the technology-focused buyout firm, pointed out that the downturn will make 2008 a more difficult year to exit from investments. Managers of recently acquired companies will need to pay close attention to operating fundamentals because those companies are carrying more leverage than in the past. One advantage for private equity sponsors in this cycle, he added, is that most large-cap buyout firms have built up substantial operating groups with in-house expertise to help companies move through the downturn. "Our ability to actually work with our costs, restructure operations and drive value is a huge added benefit going into a time of economic weakness."

The largest limiting factor now is that sellers' expectations have not caught up with the new pricing realities.

Private equity sponsors also own better companies than they did in past downturns, Mondre noted. During the most recent period of private equity expansion, sponsors were able to acquire an increased number of large, stable companies with leading market positions than in the past. Those are the types of companies that are best able to weather a soft economy. "In any downturn, it is the leaders that come out with the highest market share and better margins," he said. "The weaker competitors fall by the wayside."

New Models and Markets

On the investing side of the business, a weak economy creates buying opportunities, Mondre said. "Historically, the best buyout investments have been made coming out of a recessionary period." In the last five years, capital had become a commodity; now, because much of that capital has dried up, private equity funds may play a new role, he noted. Previously, private equity sponsors used war chests raised from limited partners to buy out firms. In the future, that money may be a source of financing for companies that are struggling with balance-sheet problems but do not want to go along with a buyout. "We can structure minority investments, do acquisition finance and other types of structured transactions that are not the traditional 'going private' that we have seen in the last few years," Mondre said.

He added that the consortium, or club, structure may still be valuable in smaller transactions because private equity sponsors can prosper from one another's strengths. "We benefit from some level of humility. We don't think our firm knows everything there is to know," he said. "Having one or two other firms as part of a deal going in from a diligence standpoint, and after the deal's closed for shared governance and shared knowledge, is a very valuable thing for bigger transactions. We actually are happy and okay with taking a little smaller investment to bring in those added skills."

"You will see more situations where there is a need for capital, and that's something private equity can provide."

Richard Schifter, a partner at Texas Pacific Group (TPG) with expertise in bankruptcy law and corporate restructuring, noted that during the recent private equity boom corporate executives turned to private equity because it could supply capital at lower cost than public financing and allowed management to escape the "limelight" in the post-Enron era of public scrutiny and regulatory reform.

Now, he said, those trends no longer shape the market, but private equity can still play a role in corporate financing. "You will see more situations where there is a need for capital, and that's something private equity can provide." Transactions could involve private equity partnerships with strategic buyers, or deals in which companies seek out leverage to avoid giving up equity. "It may be very opportunistic in light of what's going on both in the economy and the financial markets," he said.

In fact, some novel transactions have already emerged: In mid-April, Citigroup confirmed a sale of $12 billion in leveraged loans to TPG, the Blackstone Group and Apollo Management — an attempt by the bank to insulate itself from further writedowns on debt, including loans it made previously to fund transactions at all three private equity firms.

Recently, sovereign wealth funds, or state-owned investment funds, have begun stepping in to provide capital for struggling companies like Citigroup: In November, the Abu Dhabi Investment Authority, flush with cash thanks to high oil prices, bought a nearly 5% stake in Citigroup to help cover losses from subprime loans and related securities. But while sovereign funds are clearly on the rise, Jordan Hitch, managing director at Bain Capital, said he does not view them as significant competitors for private equity. "They do have capital and certain people who look for investment opportunities," he said, "but not the same capabilities as private equity funds in expertise and global reach."

In addition to new transaction structures, buyout firms are looking toward new geographies to cope with the credit crunch. "All the major firms are spending time and energy building investment teams in Asia," said Hitch, who noted that many firms had begun to focus on Europe several years ago. Firms would also likely turn to emerging markets like India, South Africa and Turkey, he added.

A Boom for Distressed Investors

While the current down cycle has demanded out-of-the-box approaches from buyout firms, it has also created ample opportunity for distressed investors seeking to buy up the securities of troubled companies.

"There's not enough money out there to deal with all the problems," said Marc Lasry, chairman and chief executive of Avenue Capital Group in New York, who joined a panel discussion on distressed investing at the Wharton conference. "[People] are panicking, and things are getting worse — and the more people who believe that, the better it is for us."

In fact, the situation is "unprecedented," according to Maria Boyazny, a New York-based managing director with Siguler Guff. "Over the next year, $500 billion in subprime mortgages are maturing. The cash-debt market gets a lot of press, but even scarier is the $1 trillion in [corporate] leveraged loans that are maturing."

Lenders and investors alike are only beginning to grasp the new pricing realities that have resulted from the downturn. Recent chaos in the market has been complicating analysis, Boyanzny said, but some firms may be ignoring the market's signals because they don't like what they're hearing. "Banks are complaining that there are no bids for securities that they have to mark to market," she said. (Under generally accepted accounting principles, publicly traded companies must estimate the market value of their tradable securities each quarter and record that value on their books.) "I'm being told that you can get bids, but you might not like where the bid is. Banks are marking things at 60 [cents on the dollar], where the active bids are 20. People are bidding 50 cents on the dollar for Triple A debt."

Many investors are facing rude awakenings when they try to refinance debts or unload downgraded bonds. Lasry recalled one investor who got angry upon being told that the discount he was offering Lasry to buy his bonds wasn't steep enough. "I had to remind him that the market price is what someone will pay you, not what you want to sell for."

Partly, investors are working through the necessary but painful process of squeezing out the excesses of the recent real estate and credit bubble, when lenders offered a variety of new types of loans without fully appreciating the risks. Subprime mortgages, the majority of which went to riskier-than-usual borrowers, were among them. So were so-called "covenant-light" loans, which placed few restrictions on corporate borrowers.

"The market discounts that lack of covenants," Lasry said. "Those bonds are now trading at huge discounts. Without covenants, I'll pay you 40 or 60 [cents on the dollar] instead of 80."

Banks in Europe and Asia were just as loose with their lending standards and equally willing to try unproven products, Boyazny added. As a result, their reckoning could come soon, too. Asian banks might be protected, at least partly, by Asia's economic boom, she noted. A surging economy and rising corporate cash flows can make a banker's rashness look like prudent risk-taking.

For buyout firms, though, the rapid downturn in credit markets remains unsettling. "There is a desire by private equity investors to capitalize on the major dislocation," Hitch from Bain Capital said, "but also a fear of not really knowing where the bottom is." ✦

Private Equity Abroad: Despite the Credit Crunch, Opportunities in Developed Markets Are Waiting

With the collapse of credit markets, firms are increasingly willing to tread into unknown territory to find new opportunities abroad. A PricewaterhouseCoopers report on private equity investment (citing Thomson Financial data) noted that international buyers accounted for 23% of all U.S. mergers and acquisitions in the first 11 months of 2007. These cross-border deals totaled $354 billion, up 73% from the 2006 full-year total.

"The U.S. is particularly attractive because the U.S. dollar is at an all-time low," Greg Peterson, a partner in PricewaterhouseCoopers Transaction Services, stated in a press release about the report.

> "There's plenty of business to do, particularly in the UK, Germany, France and the Nordic countries."

Opportunities for investment in Europe and Asia are equally abundant, say private equity experts. Although individual markets have their inherent challenges, adopting a global strategy may be one approach to weathering the current economic slowdown.

"There's massive potential for private equity [in Europe]," said Vince O'Brien, director of London-based Montagu Private Equity and immediate past chairman of the British Venture Capital Association. O'Brien, who participated in a panel discussion with other industry experts from Europe and Japan at the 2008 Wharton Private Equity Conference, noted that an analysis by Montagu found the total of all private equity deals in Europe in 2006 to be $150 billion, compared with the $12 trillion to $13 trillion total value of European stock exchanges. "We're actually a small portion of the European economic environment. In Western Europe, we do have a very attractive, strong private equity industry and I think there's plenty of business to do, particularly in the UK, Germany, France and the Nordic countries."

The London private equity firm 3i, with $16 billion under management, expanded in Europe 10 years ago and now has 60% of its assets outside the United Kingdom. In Asia, it is focused on India, China and Southeast Asia. Patrick Dunne, group communications director, said 3i views Asia as a "triple play." First, Asia represents a chance to make high-growth investments, he noted. Second, 3i has learned through its European portfolio companies that firms in developed countries need access to emerging economies in Asia. Third, he said, Asia is a hot market for exits. Companies that expected to exit private equity ownership in 7 to 10 years are exiting after only a few years amid a "flood" of exits expected to continue in China and Southeast Asia in the next two years. "We have underestimated dramatically how quickly exits would come in Asia," Dunne said.

UK investors often question whether taking a minority stake in a Chinese company is "sheer madness," Dunne added, because of corruption and state intervention in markets. On the contrary, his firm has had more problems with flat-out accounting fraud in Germany and Italy than with any problem in China or other Asian nations.

"We've made mistakes along the way — some of them hugely entertaining, some less so — but in terms of potential, our continental European business is 40%, and I think Asia has the potential to exceed that quite soon," Dunne said.

Hiroshi Nonomiya, representative director and managing director of RHJ International Japan in Tokyo, specializes in industries including automotive parts and financial services, as well as cross-border roll-ups. He said private equity opportunities in the Japanese market are growing as a result of spin-offs from conglomerates that have grown too large to effectively manage their subsidiaries.

The biggest challenge in developing private equity deals in Japan, he noted, is persuading CEOs to sell a business unit. CEOs and company presidents are typically capping off careers of 35 years or more and are not interested in upsetting the status quo with a private equity transaction. Compared with their counterparts in the United States and other countries, Japanese executives hold less equity in companies and have less to gain from a leveraged buyout. "In many cases, they want to spend those last two or three years peacefully," Nonomiya said.

A Pan-European Approach

Colm O'Sullivan, principal with PAI Partners, a pan-European private equity fund spun out of French Banc Paribus in 1999, said his firm has investments spread across nine countries. More than half of the companies PAI looks at operate in more than one country and most are pan-European or global. "They often have assets in more than one market, but if they are in only one market, I can almost guarantee that over time they will become a pan-European company," he said.

Since the introduction of the euro, consolidation in Europe has accelerated, O'Sullivan noted. Still, vendors, management teams and regulators can be very country-specific. A pan-European approach can give private equity firms the ability to both envision an opportunity and put it into motion. To do that, O'Sullivan's firm maintains a matrix organization. "We look at assets right across Europe and across sectors," he said, "and then we have local offices in Madrid, London, Munich and Milan where we try to have the local content, someone who speaks the languages who's an insider in the market locally."

This allows the firm to be aware of the regulations and intricacies of doing business in the country, he said. "But also we can see deal opportunities across Europe and opportunities to combine companies, or ways in which we can compete and learn lessons from elsewhere."

That approach has provided PAI Partners with insights into France, for example, that not all competitors may have. "The external pessimism about restructuring and redundancies in France is a great barrier to entry to other people coming into our market because we can be more confident about what it will cost and how quickly we can do it in terms of restructuring, closing factories, etc. And so it gives you a certain higher expected value, because you're more certain of the probability of success and what the costs are."

A pan-European approach can give private equity firms the ability to both envision an opportunity and put it into motion.

The Challenge of France

Thierry Timsit, managing partner and cofounder of Astorg Partners, which specializes in mid-market buyouts in France, said France is often depicted as one of the most difficult European markets to address for foreigners. "We don't speak English. We hate capitalism and globalization. We love smelly cheeses and our president [is married to] a top Italian model. This is not easy to address for Anglo-Saxon investors."

According to Timsit, France has a large number of family businesses spawned by post-World War II entrepreneurs who are having trouble with succession plans and would like to find a way to liquidate at least some of their equity. Half of Astorg's business is with family-owned firms, with owners reinvesting 25% to 49% of the firm's value, he said.

Another strong market is spin-offs from large corporations that were created by the government from the 1950s through the 1990s and that are now being turned over to private investment. "That has created bread and butter for private equity players stripping out these large corporates," Timsit said. He noted that it is more difficult to take public companies private in France than in the United States because of tax rules and other regulations. For example, to deduct interest on loans, private equity sponsors must control 95% of the target firm. In addition, conditional offers are not permitted.

Timsit acknowledged that French companies are required to offer rich benefits and protections to labor, but at least those costs are clear to acquirers, he said. "When you know that in advance, it's not going to get any worse. The only way it will move is to get better."

Proprietary Deals

When it comes to deal sourcing in Europe and other developed markets, proprietary deals seem to be a thing of the past — or at least fraught with hidden complexity. "First of all," Timsit said, "no deal is proprietary. I mean the only proprietary deal is the vendor. Anyone can claim they own the deal, but the real owner is the owner of the company."

Where proprietary deals do exist, Timsit said, often complications exist, too. Timsit's firm concentrates on "complex situations where we have conflicting shareholders or regulatory hurdles which are very French-specific, or virtually no free cash flow or very poor bankability of the deal. In these situations, you sometimes find a proprietary deal or deals where the owner is ready to talk to you without an investment bank."

Even so, he said, the owner is going to talk to someone else to see whether he's getting a fair price. "In that case, he normally continues with you if you've been fair," Timsit said.

Montagu's O'Brien said another sourcing strategy was to groom prospects. "All of our origination effort is actually targeted at the CEO of a large subsidiary who perhaps is running a good company and perhaps we think may be non-core one day." The strategy has paid off a few times. "We've found CEOs, we've gone to vendors —usually private groups — and we've caught them at just the right time. They've said, 'Well, if you can do it in eight weeks, you can have it.' But it's rare."

More straightforward situations usually mean competition. "If you're chasing plain-vanilla deals," Timsit said, "it gets very much intermediated, and [there are] no proprietary deals."

Effects of the Credit Crisis

The credit crisis is being felt differently around the world. In Japan, the impact has not been so harsh, because the economy did not participate as much as other nations in the recent boom, Nonomiya said. "Fortunately or unfortunately, Japanese banks were not so invested in subprime products." Japanese banks are still aggressive in debt financing, but "if we look for much bigger deals with international banks, then we have limitations." He noted that many Japanese companies are highly leveraged.

Timsit said European loan default rates are at historic lows of less than 2%, although the cost of debt is rising. His firm has financed two deals since the credit crisis erupted and the banks involved in those transactions have demanded more due diligence than they had beforehand. "It's going to be a more lengthy process to get debt. The cost of debt is rising, but we're coming from a point in Europe that was much lower than in the U.S," he said.

According to Dunne, the contraction in credit markets has had a chilling effect on large transactions in Europe, but mid-market deals are still being financed. He said broader economic weakness that may result from the credit squeeze is a bigger concern. "The big influence that no one is actually near estimating is the macro impact of this. The price of debt is one thing, but actually two-thirds of the business is in earnings growth," he said. "We're more interested in the price of earnings than the price of debt." ✦

Will Changes in Taxation Affect the Competitiveness of U.S. Private Equity?

Supreme Court Justice John Marshall famously declared that the power to tax is the power to destroy. At the 2008 Wharton Private Equity Conference, industry experts invoked Marshall in spirit, if not in name. The typically tedious topic of taxes sparked a lively — and occasionally acid — debate among members of a conference panel titled, "The Impact of the U.S. Tax and Legal Environment on Private Capital Competitiveness."

According to some industry experts, U.S. congressional proposals to raise taxes on their industry could hurt it significantly, and perhaps even force it to move offshore.

Given the forthcoming U.S. elections and the likelihood of a broader tax discussion next year, the debate on carried interest may be moot for the moment, but the panelists agreed that it's a hot-button issue.

"Carried interest" refers to the portion of a private equity fund's profits that the fund manager receives. In the common "2 and 20" arrangement, for example, the manager typically gets payouts of 2% of the capital committed to the fund as a management fee, as well as 20% of the fund's capital gains as carried interest.

Since Congress lowered the tax rate on capital gains to 15% in the 1990s, carried interest has been taxed at that rate, instead of the higher tax rate for ordinary income. Critics say that's inappropriate because private equity managers don't have to risk their own money to receive their share of the profits. Thus, the argument goes, they're being compensated for their services and should be taxed at the ordinary income tax rate. (Private equity managers can invest in the investment pools that they manage. When they do, the return on this money is taxed, without controversy, at the capital gains rate.)

Last year, Congress proposed taxing carried interest at the ordinary income tax rate, typically 35% for high earners. Not surprisingly, that set off a firestorm of protest in the private equity industry.

Mark Heesen, president of the National Venture Capital Association, summarized the industry's point of view. "Historically, the Treasury Department and the IRS have said that carried interest is considered capital gains," he said. "I've worked with the Treasury on many issues, and never was there any talk about this being a faulty premise. Then you fast forward to today, and you hear these arguments that all we do is provide a service, and our pay should be exactly like a janitor's pay. But we're more akin to founders and owners of companies than employees."

Last year, Congress proposed taxing carried interest at the ordinary income tax rate, typically 35% for high earners.

Owners or Employees?

Charles Kingson, a lecturer at the University of Pennsylvania's law school, said that legal logic contradicted the industry's position. "Carried interest treatment implies you have an interest in the property," he said. "The fact that your compensation is measured by the size of an asset doesn't mean that you own that asset. A jockey who gets 10% of a purse doesn't own the horse."

Instead of being paid for the use of their capital, as owners are, private equity managers get compensated for their "skill and knowledge," Kingson said. They typically manage other people's money, not their own, so they're more akin to employees than entrepreneurs. "It's like comparing a newspaper reporter to J.K. Rowling," author of the Harry Potter books, he said. "When J.K. Rowling writes a book, she carries all of the risk. When a newspaper reporter writes a story, his paper carries the risk, and he's paid for his services — just like a private equity fund manager should be."

Legal considerations aside, changing the taxation of private equity could hurt one of the most vital sectors of the economy, one panelist said.

Private equity managers also fail another legal test, he argued. When they sell a company in their portfolio, they're not selling goodwill — that is, intangible assets like reputation and customer relationships — that they have created in their business. "Look at the guy who owns a hardware store," he said. "If he sells out, he'll get capital-gains treatment because he created the goodwill. He's selling his intangible assets in a one-shot deal and packing up for Florida. Fund managers aren't selling their goodwill. They're continuing to use their goodwill."

Tom Bell, a New York-based partner with the law firm Simpson, Thacher & Bartlett, argued that the role of private equity managers wasn't as clear-cut as Kingson portrayed it. They don't simply sell their skills the way a lawyer or doctor does, he said. Instead, they're entrepreneurs who contribute sweat equity to the betterment and, ultimately, profitability of the companies in their portfolios. "If you and I set up a company and I contribute sweat equity, I'll get capital gains when the asset is sold," he pointed out.

Legal considerations aside, changing the taxation of private equity could hurt one of the most vital sectors of the economy, he said. "In most of the rest of the world, the taxation is lower for carried interest. It's lower in the UK and Germany. In a globalized economy, where will the profits go [if these proposals are enacted]?" Firms and their professionals would migrate rather than pay steeply higher levies in the United States, he suggested. Bell also questioned lawmakers' motivation in trying to raise taxes on private equity firms. "Members of Congress who are making these proposals aren't trying to do neutral tax policy," he said. "They're trying to nail one group."

An Industry under Scrutiny

The private equity industry has come under scrutiny lately because of the wealth of some of its best-known practitioners and because of political concerns over growing income inequality. Stephen Schwarzman, billionaire chairman of The Blackstone Group, for example, became a lightning rod after throwing himself a lavish birthday party in New York last year. The red-carpet bash, reported to have cost more than $3 million, included a private concert by Rod Stewart. Schwarzman's firm went public last year in a deal that netted him more than $600 million in cash and valued his stake at more than $5 billion at the time of the transaction. (Blackstone shares have since fallen.)

Some politicians, perhaps trying to stir populist passions, have complained of a new Gilded Age in which financiers like Schwarzman potentially pocket hundreds of millions for making private equity deals while working people worry about stagnating paychecks. Kingson, for one, was sympathetic to the populist perspective. "The idea that the buyout people think that they should be favored by the tax law is incredible," he said. "They make a lot of money by savaging the tax law." He also took issue with the notion that higher taxes would push private equity firms abroad. "In 1963, the top tax rate was 91% and people still wanted to become lawyers. Tax is a factor in economic decisions, but it's not determinative."

Jeff Peck, chairman of Johnson, Madigan, Peck, Boland & Stewart, a Washington lobbying firm, pointed out that, for now, the debate over carried interest is probably moot. After threatening higher taxes last year, Congress chose not to act, giving the industry a reprieve. Legislators probably won't move forward with a carried-interest measure this year because of the election, he said. The earliest that they would revisit the issue would be 2009. By then, "you're going to see a new president and probably larger Democratic majorities in both houses of Congress," he predicted.

Chances are, the Democrats will then want to pursue broad-based taxation changes modeled after, say, the Tax Reform Act of 1986 in which Congress lowered tax rates in all income brackets by removing a raft of loopholes. "We're past the point of carried interest being a solo tax issue," he said. "It will be caught up in the larger tax reform debate."

"We're past the point of carried interest being a solo tax issue. It will be caught up in the larger tax reform debate."

Heesen, of the Venture Capital Association, agreed that the industry had been spared for now. "Congress is looking at a stimulus package [for the economy] right now, so they're not going to destimulate venture capital and buyouts. It's very difficult to see them taking up a carried-interest provision in 2008 because of the election and the stimulus package." ✦

Setting up Shop: What Does It Take to Establish a Private Equity Firm in Today's Market?

Establishing a private equity fund as a founding partner is the objective of thousands of practitioners across the industry. For the fortunate few, success has involved talent, good timing and perseverance combined with industry growth that has supported the entry of new firms. With the market continuing to mature, what are the hurdles, and what will it take to successfully start a private equity shop going forward? A leading private equity fundraising advisor and two leading investors with extensive experience advising and backing new private equity firms discussed these issues with members of the Wharton Private Equity Club (WPEC).

> Most spin-outs today are the result of younger partners developing into full partners with the desire to have more of the carry and more influence within their respective firms.

Greg Myers is managing director of the Private Fund Advisory Group at Lazard & Co. He has 12 years of experience advising private equity firms across Europe, the United States and Asia on fundraising transactions. Currently based in London, Myers is responsible for Lazard's European and Asian fundraising origination and execution activities.

Mike Pilson is director of Private Equities at DuPont Capital Management. He has 12 years' experience in private equity fund investment and investment banking. Pilson currently oversees a $3 billion portfolio comprising over 100 private equity fund interests.

Rick Slocum (WG'85) is director of Private Investments at the Robert Wood Johnson Foundation. Slocum has 27 years of experience across private equity fund investment, direct investment and investment banking and was most recently senior director of investments at the University of Pennsylvania. He currently oversees a $2.5 billion portfolio in commitments with investments in private equity, venture capital, growth equity, distressed investing, opportunistic credit and real assets.

WPEC: In your experience, what are the different profiles of new private equity firms, and what motivates new general partner teams to set up shop?

MP: New private equity firms typically come in one of a few forms today. First, a spin-out of a sub-group of partners from an existing firm — for example, West Hill, a recent spin-out from the established U.S. buyout firm J.W. Childs. Second, a spin-out of a group of partners from different firms that have teamed up, such as Vitruvian Partners, a European private equity firm that was established last year by ex-Apax, BC Partners and Bridgepoint investment professionals. Third, a new firm formed by individuals that have been practicing private equity-like investing in a non-fund format, such as Intervale Capital, which was started recently by Charles Cherington and Curtis Huff. In each scenario, the motivations are different but the goals the same: to have your own shop — one where you have designed the investment process, strategy, and team economic structure to achieve the best team-based decision making, cohesiveness, transparency and, ultimately, the best returns. Most spin-outs today are the result of younger partners developing into full partners with the desire to have more of the carry and more influence within their respective firms.

GM: Another major profile of a new firm that can attract institutional investor funding is a spin-off from a bank. Merchant banking spinouts are often driven by strategic change in the mother organization; for example, issues with conflicts of interest or balance sheet risk considerations. Metalmark Capital, for example was spun out of Morgan Stanley in 2004. The firm went on to be acquired by Citigroup in 2007 as the bank made a strategic decision to rebuild its exposure to the private equity business.

The second motivating factor is similar to the private equity firm dynamics Mike describes. Either the whole investment team, or a sub-set, seeks independence from the mother organization for reasons including economics and ability to form and execute an investment strategy independently.

RS: I think that Mike and Greg have provided a good summary of many of the motivations one sees in forming new private equity firms. Another format I've seen includes an ex-CEO or CEOs getting together to form a new fund, sometimes with sponsorship from an established group. Operational expertise, particularly when combined with investment experience, can be an attractive format. Also, new areas for investment — for example, private equity real estate investing in India — will attract investors who may have skills in other markets that they believe can be applied in new locations.

WPEC: Private equity has emerged as an asset class of its own over the last 25 years. Historically, what has driven the demand for investing in funds advised by new firms? In your opinion, are the same demand factors driving the market for new opportunities today?

RS: If you go back to the 1980s, buyout funds could be established to exploit the inefficiencies in both the financing markets and the corporate sale process. Auctions were less frequent for awhile, while the idea of buying companies with significant leverage was pretty novel. As a result, professionals with strong financial skills and good access to Wall Street could raise funds to exploit financing inefficiencies. Strong returns could be generated by successfully cutting costs and reducing leverage of strong cash-flowing entities. Today's market is much different, and, at least in the U.S. and now Europe, is looking for strong operational and business-building skills. In addition, popular investing themes — where skill sets might be somewhat different — include investing in the emerging markets and in real assets.

The new wave of firms will be driven by the next generation of private equity firm partners — newly energized and highly aligned, and with innovative ideas for embracing new market opportunities.

MP: Private equity has emerged from a cottage industry into a fully fledged asset class over the past 25 years. The driving reason is the consistent alpha generation to institutional investors as a result of market inefficiencies left by other investment and ownership models that private equity addresses. Historically new firm creation was driven by the "*new* new thing". The new investment idea — for example, industry-specific, buy-and-build, or operationally focused funds — or the ability to back a new star investor, for example, J.C. Flowers in 2002 after he left Goldman Sachs, or new geographies — for example, the emergence of Europe, Latin America, and Asia. As the market matured, the number of ideas has grown exponentially. I believe the same forces continue to drive the growth of private equity today. Investors will continue to look for the *new* new thing.

GM: After years of rapid growth, I believe that we are now at an inflection point in the industry. Many established shops are maturing with potential team succession issues looming. Simultaneously, institutional investor allocation to new managers has decreased as relationships with established managers have matured. The new wave of firms will be driven by the next generation of private equity firm partners — newly energized and highly aligned, and with innovative ideas for embracing new market opportunities. Silver Lake is a good example: Formed in 1999 by partners from private equity and technology backgrounds, the firm identified the opportunity in the technology sector early. Success in this strategy attracted significant institutional investor interest, helping the firm become among the largest new players in the industry.

WPEC: The last few years have been strong for overall fundraising in the developed markets of the U.S. and Western Europe. What are the primary challenges for new firms fundraising in these developed markets? How have these challenges been overcome?

> Over the next couple of years, raising capital will be tougher, particularly for new funds.

GM: In the developed markets, much of the dramatic headline-grabbing increases in fund sizes have been driven by market tenure and institutionalization of incumbent firms. Many have built 20-year-plus track records, proving the capabilities of their teams and rigor of their investment processes. This has assisted with establishing brands and reputations with both fund investors and markets for sourcing and financing investments, which is pivotal for raising and deploying capital. Team sizes have grown as roles have specialized to capitalize on the breadth of and competition for a range of investment opportunities across sectors and regions. At the same time, established firms have been able to stem team turnover by vesting members with carry. In short, many of the early investment strategy and organization risks posed to fund investors have been mitigated while returns have remained, allowing these firms to attract larger portions of available funding. Overall, given the opportunity set of proven and established managers, the bar for new firms is high.

RS: The last few years have broken records in terms of fundraising. Over the next couple of years, raising capital will be tougher, particularly for new funds. The new funds that will be successful will have many of the following attributes: strong principals who have invested successfully someplace else before; high integrity; a demonstrated ability to work together as a team; a strong alignment of interests between the principals of the GP and the LPs, which should include a strong personal financial commitment to the fund and back-ended carry (where the GP receives a profit share only once the fund as a whole begins to make a profit, rather than as soon as the first investment makes a profit); some sort of edge the team has to differentiate itself; a good combination of operating and financing skills; and probably a theme, such as distressed investing, consistent with the world as we know it today.

MP: The current fundraising environment in the U.S. and Europe is particularly difficult for new firms. LP capital is directed increasingly to re-investments in subsequent funds of GPs with whom the LPs already invest. Thus, there is simply less capital for new relationships and new firms. Compounding this will be overall lack of risk appetite among LPs in an uncertain economy and investment environment. The goal for a new manager should be to gain the attention of LPs in an otherwise crowded fundraising market. This may be accomplished by being very attentive to terms, structure and possibly offering a co-investment in a portfolio company or a secondary fund interest as a means of jump-starting the relationship.

WPEC: Everyone is talking about emerging private equity markets such as China and India. Are these any more favorable for new fund managers looking to establish private equity funds? In your opinion, in which other countries is there a particularly interesting opportunity for new groups?

MP: China and India have dominated the private equity discussion for the past three years. Significant amounts of capital have been raised in those markets by all types of fund managers. Most of these managers have at least one thing in common: they did not exist five years ago. Institutional LPs have been very accepting of new managers from this region, many of which have demonstrated strong networks and or business-building skills. These characteristics represent the bare minimum skill-set expected in mature markets. However, LPs are looking for a means to gain exposure to these developing markets that have double the underlying growth and a relatively less-competitive private equity environment.

RS: These markets are much more favorable for new fund managers looking to establish themselves. China and India will be developing for quite some time, and managers with relevant skills can certainly still form funds. We also believe that the skill set required to be successful in these markets will evolve over time, but that they are often quite different from skills required in the U.S. or Europe. As for other countries, Brazil and Russia are the two largest scalable countries, but we see opportunities in Eastern Europe as well. Growth capital funds have been forming in the Middle East, too, though we worry that this region may actually have too much capital already.

GM: Fewer established competitors and an imbalance of the supply of capital and availability of compelling investment opportunities make early entry to some of the emerging markets favorable. Typically, the profiles of new shops are either experienced investors returning home from developed markets, or well-connected local individuals from banking or industry backgrounds. Both profiles of new shops will face the challenge of limited or no track record in the target region and in some cases may also face the challenge of very limited market activity to point to, purely due to the stage of market development. Selling the market and investment thesis then becomes a major challenge when approaching institutional fund investors. We find that, as a result, these opportunities are funded by investors who are able to analyze the risks and take a long-term view — typically endowments, fund-of-funds, hedge funds and other thought-leading institutions.

WPEC: What are the most important factors that you evaluate when underwriting "first fund" opportunities? Do these factors differ, if at all, from your analysis of established players?

MP: The single most important factor while assessing a first-time fund is a differentiated strategy. While the strategy is not the only factor to be considered, it is a nonstarter if the strategy is a "plain vanilla" LBO or a similar, "me-too" approach. As there is more firm or partnership risk with a first-time fund, the question with these strategies is: Why take on the perceived extra risk for a non-differentiated strategy? In addition to strategy, the analysis for first-time funds is often centered on deal attribution, who did what at the previous firm, strength of team and how they worked together in the past, terms and alignment of interest. Established players, on the other hand, may be evaluated more on team, track record, investment strategy and organizational dynamics.

Fewer established competitors and an imbalance of the supply of capital and availability of compelling investment opportunities make early entry to some of the emerging markets favorable.

GM: There are a number of due diligence items that we emphasize when we evaluate a client on a potential first-time-fund assignment. The first is investment team chemistry. In addition to demonstrating that they can work together — perhaps through overlapping prior backgrounds — do they have the conviction and passion to weather a fund raise and establish an independent enterprise? Deal flow visibility is also very important. In the new setting, we want to be sure that the manager will be able to source attractive investments that are consistent with their thesis and the expertise demonstrated by the prior track record. Then, as a placement agent, investor demand is also key — we want to have foresight on market demand before taking on an assignment.

WPEC: At the time of going to press, the LBO markets were challenging due to the credit crunch. Comment on the current market environment for fundraising/investing in private equity funds. Has this, or is this expected to impact the fundraising market for first-time funds?

GM: The market events of August 2007 ended a robust 2003-2007 fundraising cycle. Currently, sentiment is one of caution. Thematically, investors are seeking counter-cyclical and risk-mediating investment strategies, such as distressed/turnaround and mezzanine. At the same time, investors recognize that their 2001-2003 fund investments outperformed due to the market conditions. Now may be a time to replicate those strong vintages, particularly by backing managers that have a history of investing successfully through the cycle. On balance, first-time fundraising difficulty does increase, but is by no means impossible. Expectations should be to achieve a reasonable fund size adequate to execute the stated strategy. The emphasis on having a strong institutional investor base increases because these are the partners you can rely on to remain supportive if you exhaust available capital in a short time period.

The key word in the limited partnership agreement…is "partnership."

RS: In the current market, individuals with, for example, good distressed investing skills will have an easier time of fundraising than traditional buyout investors. There may be room for first-time energy sector investors in this market, and certain areas in venture capital, such as clean tech investing, should have some success. First-time funds that require leverage will have problems, as there is a distinct possibility that the current buyout industry could suffer a shakeout. In all cases, however, individuals will need to have developed real expertise someplace else first — don't try to raise a first-time fund unless you've invested before and have a verifiable track record.

MP: Without question, the current environment has limited both the fundraising and investing activities for many private equity strategies. However, there are opportunities in every market. Specialized strategies that take advantage of the current environment should be of interest. For example, mortgages, financial services or distress and restructuring. Likewise, investors that target smaller companies where some leverage may still be available could have success raising capital. However, I agree with Rick: New GPs should think long and hard about entering this market without a well-differentiated strategy.

WPEC: What are the current economic and governance terms for new general partners raising private equity funds, and where are the hot-buttons that help them gain traction?

MP: The key word in the limited partnership agreement — the contract between fund investors and the private equity firm — is "partnership." With first-time fund managers, we always look for a fair but reasonable agreement. Governance is an important element when we assess a partnership agreement. We like to see, at minimum, a strong key-man and a no-fault divorce (LP consensus termination) clause. We like to see the first-time manager address the firm risk elements — such as the potential for team misalignment or even departures — proactively in the agreement as a sign of good faith and a demonstration of the appreciation of the LPs' perspective when underwriting a first-time fund. Additionally, strong governance clauses give LPs some comfort with first-time funds, as the conventional wisdom is that a 10-year fund life can be more volatile than the same 10 years at an established firm.

GM: Economic alignment of interests is central to structuring private equity funds, and due to the uncertainties of backing a new organization, the emphasis on this increases for new shops. New fund managers will generally be beholden to the market on many terms — 2% management fee and 20% carried interest, for example. Team monetary commitment to the fund acts as a very important signal to investors. This is currently at least 2% of the fund, and often more to match an absolute quantum that is perceived as "meaningful." The other consideration, which is often a temptation for first-time-funds, is favorable economic or governance incentives to certain "cornerstone" investors. These arrangements should be approached with caution as they often represent considerable hurdles for other investors due to potential conflicts of interest.

RS: Alignment of interests is imperative. We would look to make sure that the management fees generated from the fund are enough to meet a reasonable operating budget for the fund, but would then require a "back-ended" carry structure. As for the size of the GP's commitment, we would take into account the liquid net worth of the principals, which may allow for a lower threshold than Greg's figures. As for governance, sponsorship by a bank or other financial institution can be a "mixed bag." For example, a motive of a fund established by an investment bank could be to facilitate banking fees — maybe, maybe not. First-time funds often need to accept commitments from wherever they can get them. Some LPs will look at the composition of the LP base to figure out if their interests are aligned with other investors. Insurance companies may put capital into a fund really to facilitate debt transactions. Who controls the investment decision — are certain LPs on the investment committee? — is an important thing to consider with a first-time fund.

WPEC: What is your parting advice for budding general partners aspiring to set up their own shops eventually?

RS: Having worked on both the buy side and the sell side, I would recommend that you look in the mirror and try to figure out what is really important to you before deciding you want to do this. It can be done, but raising a first-time fund will likely be a very long and gruelling process. To be successful, work someplace else first — another PE firm ideally, or perhaps as part of a bank or merchant bank — develop a meaningful track record, try to develop strong relationships with LPs and/or angel investors — anyone who you think may support you (and provide good references). Understand that many of the LP's who invest regularly already have mature investment portfolios and are not in need of many first-time funds in their portfolio.

GM: Timing vis-a-vis the development of your track record is extremely important. You should be able to show that you have led a few investments through sourcing, structuring and creating value to profitable exit realization. These investments should also demonstrate consistency with the investment strategy and differentiation of the new organization. Ideally, the details of your track record should be portable to the new firm setting. You should also have a range of supportive references on hand — for example, portfolio company management teams, professional services providers who have worked with you and colleagues from your prior organization. Finally, bear in mind that institutional investors typically look for multi-fund relationships. A clear vision for the new shop over the short-, medium- and long-term is therefore key.

MP: My additional advice would be to network with established LPs prior to setting out on your own. The more input one can get on strategy, team composition, terms and other organizational elements, the better one can position the new firm. However, you must be open to feedback. This is also a good way to build relationships and get real feedback from the institutional investor base. ✦

Carlyle Group's David Rubenstein: 'The Greatest Period for Private Equity Is Probably Ahead of Us'

David Rubenstein is co-founder and managing director of The Carlyle Group, the Washington, D.C.-based private equity firm with more than $70 billion in assets under management. In March, members of the Wharton Private Equity Club (WPEC) interviewed Rubenstein about the ongoing credit crisis, the industry outlook, the rise of sovereign wealth funds, and why private equity is "one of the greatest exports of the United States." An edited version of the conversation appears below.

WPEC: How would you describe the near-term outlook and long-term projections for the private equity industry?

Some of the greatest growth opportunities for private equity moving forward are in China and India and other so-called emerging markets.

Rubenstein: From 2002 to mid 2007, you saw the Golden Age of private equity. Now we're in a period that is the post-Golden Age. During this period of time, probably for the next year or so, you'll see much smaller deals done. The large deals won't get done because there's nobody to syndicate those deals. Secondly, you'll see non-levered deals where people take minority stakes but they don't use leverage as much. And you'll see much more overseas activity from the private equity firms in places such as China or India where leverage in many private equity transactions is not quite as important. It's clear that some of the greatest growth opportunities for private equity moving forward are in China and India and other so-called emerging markets. And as a result, more and more firms will begin to invest overseas.

But once this period is over, once the debt on the books of the banks is sold and new lending starts, I think you'll see the private equity industry coming back in what I call the Platinum Age — better than it's ever been before. What you'll find is that private equity will continue to attract enormous amounts of equity since the rates of return have been consistent and better than anything else you can legally do with your money. And as a result, I think the private equity world will grow even stronger. You'll see more people getting in — individual investors as well as institutional investors from all over the world.

I also think that private equity firms will grow to be much larger organizations than they are today. And most will probably become public institutions. Of course, not all PE firms will be public institutions. There will be enormous opportunities for new firms to get started. But I do think that the private equity industry has a great future and that the greatest period for private equity is probably ahead of us.

WPEC: Is the current credit crunch a secular or cyclic trend? Will leverage for buyouts return in time for LPs and professionals to stay with the industry?

Rubenstein: The last downturn we had in the U.S. was in 2000-2001. It took roughly three years for leveraged loan volumes to match their previous highs after 2000. And those three years were challenging for private equity investors. In 2001 and 2002, U.S. leveraged loan issuance fell to approximately a third of its 1998 total. But when the recovery came, it exceeded all expectations. Leveraged loan issuance more than doubled between 2002 and 2004 and again between 2004 and 2006. Issuance jumped 20 times between 2001 and 2007. So if you look at these trends you can see a clear cyclic element.

WPEC: You have said the PE industry is in its "purgatory phase." How do you suggest the industry atone for its sins?

Rubenstein: Many people in our business, including me, have not done a good job of explaining what the business is all about. Historically, when I would go raise money from people, I would say here's my rate of return. And if they liked the rate of return, they would invest more money with us. But nobody ever asked me when I was raising money all around the world, "How many jobs have you created? How many factories have you built? What's the quality of care that you're giving to workers in your companies? How many charitable contributions are you making? And what kind of taxes are you paying?"

We didn't really have that information. Our whole industry didn't really have it. And now we recognize that if we're going to be able to function the way we want, we have to be much more aware of the labor unions, the consumer groups, Congress, the media. We have to do a much better job of explaining what private equity does and why it makes companies more efficient. And so during this period of time, I think the private equity industry will spend much more time doing that, and much more time explaining to people how we create value, why we deserve to get compensated the way we get compensated, and why it is a good thing for our economy. We need to do a better job overseas as well, explaining to countries why allowing an American investor to buy something in their country is actually good and will propel their economy forward and ultimately make their companies more efficient.

WPEC: In a 2006 *Forbes* magazine article titled, "Private Inequity," the authors wrote that buyout executives "don't make their fortunes by discovering new drugs, writing software, or creating retail chains; they make their money by trading existing assets." How should the PE industry respond to such criticisms?

Rubenstein: When I was in the White House, it was generally thought that Japan would overtake the United States as a dominant economy in the world. This was in the late 1970s and early 1980s. And that didn't happen. Why didn't it happen? Well, the Japanese system wasn't as efficient as people thought at the time, but in the United States, we had become a little flabby in our economy. And we began to retool ourselves. Now, private equity doesn't deserve all the credit for it, but the techniques that private equity developed have helped to make companies more efficient. They do make workers more motivated and they do produce the kind of returns that I think enable the system to move forward and be a very efficient engineer of capitalism. This is what the data shows.

> If you give a manager a large piece of a business, if you have people who are investing in the business…and if you can operate in a private setting to a large extent, you can create value.

And by the way, private equity is one of the greatest exports of the United States. We have very few businesses in the United States right now where we're the dominant force in the world. We are the dominant leader in the world in private equity. If you take the 10 best known and largest private equity firms in the world, I think eight or nine of them are United States-based. That probably won't continue forever. But I do think the private equity industry will thrive and will prosper in part because the returns are so good and because the value creation techniques actually work. It turns out that if you give a manager a large piece of a business, if you have people who are investing in the business, putting their own money at risk, and if you can operate in a private setting to a large extent, you can create value. And we need to do a better job of explaining that to a wider audience.

WPEC: Should people invest in private equity now?

Rubenstein: The truth is that when you are in economic turmoil or when it's harder to find financing, those are historically the periods when the best private equity deals have been done. If you go back and look over the last 20 years and check when the best deals were done and when the best returns were generated, it was actually in periods like this. So it's a very good time to invest. I think one of the problems right now is that we still have a denial phase [among sellers]. As values have come down a bit, a lot of the sellers are saying, "I think my company was worth X. Now it's only worth 80% of X. So I'll wait for awhile." And sellers are probably going to take six to nine months before they realize it's not coming back to X anytime soon and so they probably will sell. But once we're through that, I think we'll see some extraordinary deals and extraordinary returns generated for investors.

> When you are in economic turmoil or when it's harder to find financing, those are historically the periods when the best private equity deals have been done.

WPEC: Do you see sovereign wealth funds replacing PE firms as preferred sources of capital for corporations looking for new capital?

Rubenstein: Sovereign wealth funds have purchased substantial equity stakes in several alternative asset managers over the last few years. China Investment Corp. invested $3 billion in Blackstone, and Abu Dhabi's Mubadala [Development Company] invested $1.4 billion in Carlyle. Dubai International Capital invested $1.3 billion in Och-Ziff. They are among the private equity industry's largest individual investors and they manage enormous amounts of money. In the future, sovereign wealth funds and private equity firms are likely to pursue large investment opportunities through joint ventures. Sovereign wealth funds will benefit from PE firms' deep pools of investment talent and deal expertise. I think the relationship will be collaborative rather than competitive to a large extent.

WPEC: What are some of the factors that you think have been responsible for Carlyle's success over the last 20 years since you founded the firm?

Rubenstein: When we started Carlyle, it used to be the case that you were in the buyout business or the venture business or the real estate business or something that was very specific. We came up with the idea that you could be in multiple businesses and have multiple funds. We now have about 60 of them. And we also, as part of this, came up with the idea of doing this around the world and so we've made it a global business. It's now at the point where we have about a thousand people and about 550 investment professionals. We've had a 26% net internal rate of return on realized corporate investments over 20 years, which is a good track record.

WPEC: Is private equity still a good industry for young professionals launching their careers?

Rubenstein: The phrase "private equity" hadn't been invented in 1987 when I helped start Carlyle. Today, I think it is a great industry for young professionals because you learn the business of being responsible for something. You learn the business and the idea of actually having accountability. You are not just an agent for somebody else. You're really making something happen. And the beauty of the business is that once you learn how to make investments, once you learn how to oversee companies, once you learn how to work with management, you can do it from anywhere. With investment banking, although it's a great business, you generally have to be in the large cities. But with private equity, you can do it almost from anywhere and you can start your own business. So if you specialize, develop knowledge in one industry, you can make a great success of yourself and ultimately find it emotionally and physically and financially rewarding. I hope all of you will, as you build your careers, always think about the society in which you live and the communities in which you live and always try to give something back to your community as well as something to your own family.

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