

PRIVATE EQUITY IN THE PUBLIC EYE

Private equity funds are coming off of a banner year. But as funds increase in number and size, is too much money chasing too few deals? Institutional investors are taking a look at how they can safeguard their private equity portfolios.



Private equity is anything but private these days. In recent months *Forbes*, *Fortune* and *BusinessWeek* each ran a cover story on the topic. Bill Clinton, along with former Democratic Senate Minority Leader Tom Daschle, have reportedly signed on as advisors to private equity firms, and such brand name companies as Toys “R” Us, Hertz and Sunguard have been bought by private equity firms in the past year.

Private equity partnerships raised an estimated \$151.8 billion in 2005 versus \$92.0 billion during 2004, according to *The Private Equity Analyst*. By some estimates, global private equity investments could reach \$300 billion in 2006.



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Speaking at a recent Wharton School roundtable on private equity, Kristin Gilbertson, chief investment officer at the University of Pennsylvania, summed up the optimism she and many of her colleagues feel about private equity’s near-term prospects. Firms that specialize in buyouts, for example, “have benefited from easy credit. Spreads are low, interest rates are low, and covenants on loans are absent,” she notes. Gilbertson adds that general partners have taken advantage of the current easy-credit environment to raise debt in the companies they’ve bought, distributing the cash in the form of dividends to the funds’ investors, boosting their returns but increasing the financial risks to investors. This practice is known in the industry as a dividend recap.

While Gilbertson and others may wonder how long these good times will last, private equity funds do possess a history of yielding above-average returns, particularly over the long term. Thomson Venture Economics reported that its All Private Equity Index returns over the 10- and 20-year periods outperformed the S&P 500 by 7.5% and 2.7%, respectively, as of Dec. 31, 2005. Buyout funds’ 10-year returns were 15.3%, and venture capital funds performed even better, averaging 17.1% over the last 10 years. The S&P 500 returned 9.1% for the 10-year period.

Given private equity’s strong returns, it’s little wonder that institutional investors continue to be drawn to it. Also consider

what some analysts see as lackluster expectations in competing stock and bond funds. This winter, the Global Private Equity Barometer found that 44% of limited partner investors surveyed planned to increase their private equity allocations, compared to 30% recorded six months earlier.

But despite that optimism, some doubts have emerged. The Barometer also found that “84% of limited partners are concerned about levels of competition in established markets, and 71% are worried about the growing size of private equity funds.” Indeed, given private equity’s surge in popularity, investors are right to wonder what their long-term strategy for the asset class should be from here on.

Expanding Universe of Private Equity Options

Fortunately there’s evidence both objective and anecdotal to suggest that private equity’s ability to perform will continue. For one thing, the potential universe of companies worthy of investment remains largely untapped, and the process for finding and investing in such companies remains relatively inefficient, creating strong return opportunities for skilled managers.

“There are more than 100,000 private companies in the United States, versus only roughly 10,000 to 12,000 public companies,” explains Robert Morgan, head of Northern Trust’s private equity division. So when making investments, private equity fund managers can choose from a much larger universe of companies. And with so many choices available, general partners can specialize in a specific niche, taking advantage of multiple investment opportunities within that niche, Morgan says.

The universe of attractive private equity targets expands even further when general partners look beyond U.S. borders. “Since the valuations of private firms have become very high in the U.S. lately, it makes sense for institutions to invest in private equity globally,” says Lena Booth, executive director of the Thunderbird Private Equity Center and an associate professor at Thunderbird Garvin School of International Management. She says the move overseas is motivated, in part, by a desire “to reap the potentially huge returns by buying undervalued foreign private equity investments,” but also for enhanced diversification benefits. “Private equity investments in the foreign markets have mushroomed tremendously,” she says.

Management Factor Allows More Control, Better Edge

Added to private equity’s diversification benefits is the ability of private equity fund managers — who typically gain one or more seats on the board — to nurture and guide the companies they back.

This “control” feature is a key differentiating factor when comparing private to public equities. Private equity firms

generally structure their transactions so that they have the ability to strongly influence key strategic decisions. They can hire and fire company management teams and sell their investments. This feature allows highly skilled private equity managers a number of avenues from which to create equity value at their companies.

The management factor also has another interesting implication. Public equities fund managers that compete in a similar niche (large cap growth, small cap value, etc.) generally own a large universe of the same stocks. Private equity managers, on the other hand, rarely own the same companies because control is concentrated with one or a select syndicate of firms. This leads to increased diversification for private equity investors and also allows the highly skilled managers to more directly distance themselves from average performers.

Volatile Returns, Delayed Payouts, Capital Costs

While lauding the return potential, Booth and other analysts readily admit that, as with all investment vehicles, private equity comes with its share of risks. Morgan at Northern Trust can list several. “On an individual deal basis, private equity returns can be quite volatile,” he says. Those risks stem from private equity’s “high leverage ratios, high business risk and uncertain exit markets.”

Moreover, limited partners must make a long-term commitment to a fund, eschewing any liquidity in the interim, which means, of course, that private equity investments by their nature come with a hefty built-in opportunity cost. “We tell investors to expect to see no positive cash flow from the investment for at least five to seven years,” Morgan says.

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BusinessWeek’s February 2006 cover story on private equity cited a laundry list of other advantages this oversight can have. For example, working with private capital that has a lengthier time horizon, management can plan a profitable long-term strategy, free of the pressures Wall Street places on public companies to show improved quarter-by-quarter performance. This allows private equity a luxury that many public companies lack: investing in projects that may be detrimental to short-term performance but create equity value over the long-term.

Private equity-backed companies are also immune to many of the costly record-keeping and regulatory hassles faced by their public counterparts. It’s a particular advantage in an era of heightened scrutiny brought on by Sarbanes-Oxley regulations.

Private equity investments in foreign emerging markets can likewise benefit from the fund’s nurturing oversight. “In many emerging markets,” says Booth, “minority shareholder interests are not very well protected.” That is a fact that makes it all the more important for the private equity fund to insist on majority control of their invested companies. Such control lets general partners “instill best practices and positive change in the company, either to improve product image or operational efficiency,” she says.

An added bonus is that best practices can give companies a particular edge in emerging markets where their competitors may still rely on outmoded business strategies, she says.

“We also tell investors to only allocate that portion of their portfolio to private equity that they feel they will not need access to for at least 10 years.”

Investors also must be mindful of capital calls. In this case, Morgan advises clients to maintain a portion of their assets in cash to meet capital calls that may occur within a year. Northern Trust also provides clients with estimates of how much capital will be called.

Another eye opener for investors making an initial allocation to private equity is the fund manager’s fees. Annual management fees can reach 2.5%, and managers may pocket 20% to 30% of the fund’s profit. The general managers consider this to be justifiable compensation for the risk exposure and management functions they take on.

Due Diligence: A Key Strategy Component

Given the downsides, investors demand much higher returns from private equity funds than from more liquid investments, such as stocks. And they’re right to insist on a great deal of protective oversight, both from those who recommend funds and the fund managers themselves.

To help provide the former, due diligence is — and always was — of paramount importance. Investment strategists need to ascertain whether the fund managers have the track record and necessary ability to generate high risk-adjusted returns,



Gaining Access to Private Equity

Smaller and mid-sized institutional investors sometimes face a challenge gaining direct access to private equity funds. Many of the industry's most sought-after funds are open to investors by invitation only and the high minimums such funds charge can put them beyond the reach of moderate-sized institutions.

Large, prestigious private equity funds can afford to set high barriers to entry, since they often can provide their investors with the most lucrative deals, including buyouts of large companies that less capitalized smaller private equity funds can't touch.

However, there is a way for smaller institutions to participate in the same desirable funds as their better-capitalized colleagues. And that is by investing in a fund of funds. As the name implies, a fund of funds divides the capital provided by a number of investors into a select group of private equity funds. By pooling capital, a

fund of funds lets smaller investors overcome the high minimums charged by larger funds.

At the same time, smaller investors still gain access to the same manager talent and priority deal flow larger private equity funds offer. Likewise, investors benefit from the knowledge and experience of the fund of funds' own management team. Since

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fund of funds managers have their fingers on the pulse of the private equity marketplace, they often know when promising funds seek to raise money. Thus, they can develop a fund pipeline that better allows them to plan when and how to allocate capital clients set aside for private equity investments.

As Robert Morgan, head of Northern Trust's private equity division, explains, "It's the fund of funds manager who spends his or her time combing through these numerous offerings, and performing exhaustive due diligence on funds in which a potential investment will be made." That includes reviewing each underlying fund manager's experience and investment style along with the resources of the manager's firm. Reference calls, analytical verification of a manager's track record and site visits all form part of this review process, Morgan says.

In return for this oversight, a fund of funds manager levies a management fee over and above the fees charged by the managers of its component funds. But fund of funds managers offer one additional service that's often dear to the hearts of small institutions who must keep their investment department overhead to a minimum. Specifically, they consolidate the reporting from all of the underlying fund managers, which can even include the thankless task of preparing consolidated K-1s for investors. "It is effectively the total outsourcing of the management of the asset class into one source," Morgan says.

says Morgan. To ensure the quality of this process, some financial managers maintain in-house analysts charged with due diligence. The approach fosters team expertise and experience, he says.

Tying Investment Strategies to Goals

Strategists should also help their clients devise a private equity strategy that meshes with their goals, Morgan says. Factors to consider: the portfolio's size and liquidity, as well as the client's risk tolerance and long-term return requirements.

Based on this input, an investment strategist can present clients with return and risk rates over a period of years further broken down by asset class. Here, for example, aggressive investors may wish to allocate from 5% to 10% of their portfolio to private equity.

"Within the private equity allocation, we recommend three things: One, diversify broadly by fund type, size and geography; two, invest consistently over time; and three, access fund managers with a history of high performance," Morgan says. ❖