Private equity funds look for strength in numbers

In recent years, surplus cash and increased liquidity have made it increasingly difficult for private equity funds to find good deals. The solution may include consortium investments and specialised portfolios

By
PETER CORNELIUS, OLIVER GOTTSCHALG and MAURIZIO ZOLLO

Thirty years ago, the private equity industry was not really an industry at all – the practice of buying shares in private companies for investment purposes was confined mainly to wealthy families, and they generally wanted to invest in small, fast-growing companies at an early stage of development. Today, private equity is mainstream, sophisticated and huge. It accounted for about $500bn worth of deals in 2005, and the vast majority of that sum was spent on buy-outs of established companies.

However, the miracle could be about to lose its shine. So many investors have piled into private equity in recent years that it has become increasingly difficult for private equity fund managers, also known as "general partners", to outperform the public markets. As more and more capital has flowed into private equity products, so the talents and resources of the general partners have been stretched to breaking point. Many funds have grown excessively from one generation to the next and, as the industry has become awash with liquidity, so it has become easier for less able fund managers to survive. Consequently, the average returns on the asset class as a whole are under threat.

With too much money chasing too few deals, the industry is putting itself through a radical restructure in the search for higher returns. For example, private equity funds are beginning to club together in order to construct huge deals, reach out globally and penetrate new markets. They are beginning to manage their investments more actively – with new governance and incentive structures, and the direct involvement of general partners in the operational and strategic decisions of portfolio companies. And they are beginning to specialise in particular industries or sectors, on the basis that they can enhance returns through synergy and collective experience.

Overall, the industry is shifting its focus back to the performance of underlying investments, and the "added value" that general partners can offer. Will this be enough to sustain its dizzying growth?

Private equity: an industry snapshot

Last year was a busy one for anyone involved with private equity, and especially for the managers of buy-out funds. They raised an unprecedented amount of capital – about €46bn in Europe and about $80bn in the US – and established the five largest buy-out funds of all time. Meanwhile, the conditions for deploying that capital were good, as both sides of the Atlantic saw continued economic growth and corporate restructuring.

The total number of deals worldwide rose significantly, with buy-outs in particular growing in size and frequency. About 100 were completed, averaging $350m in size. They included a number of mega-deals, such as: the €12bn leveraged buy-out of Wind, the Italian telecommunications company; the $11.4bn buy-out of SunGard, the US financial services and data recovery company; the $6.6bn acquisition of Toys R Us, the US retailer; and the €4.3bn buy-out of Amadeus, the Spanish provider of IT solutions to the travel industry. Venture capital also had a strong year, with the recovery of capital flows into European and US early-stage funds gathering momentum.

The knock-on effects in other industries were profound. For example, private equity deals generated substantial demand for services such as advice on mergers and acquisitions, initial public offerings and loans. Investment banks benefited to the tune of about $10bn, or nearly 20 per cent of their total revenues.

In the medium to long term, the outlook for private equity looks equally rosy thanks to various macroeconomic factors. For example, in Europe, where the entire investment portfolio "at cost", a measure of capital invested in portfolio companies, was still below €200bn at the end of last year, or less than 2 per cent of GDP. Even in the UK, Europe's most attractive economy for private equity, capital under management stands at only about 3.5 per cent of GDP. To reach the same degree of private equity activity as the UK, continental Europe would require net investment flows to increase by 10 per cent annually over the next ten years – not an unrealistic scenario given the potential demand for private equity financing.

An important source of demand will be family-controlled companies, which typically account for two-thirds of all enterprises in industrialised countries and about half of economic output. In Europe, more than 2,250 companies of this type have been involved in European private equity transactions since the early 1990s. On average, they accounted for one in every five deals and, in some years, for as many as one-third of European buy-out transactions.

A key driver of this trend is the challenge of succession, according to the International Business Owners Survey, published by accountants Grant Thornton, and encompassing 6,300 medium-sized family businesses worldwide. In Germany and the UK, for example, more than one-third of company owners say they will consider stepping down within the next 10 years, but only about one-quarter say they intend to pass the business on to their children.

Another important source of demand for private equity will be the privatisation of state-owned assets. In 2005, European privatisation receipts totalled almost €67bn. Notwithstanding buoyant stock markets, the majority of divestitures have been based on asset sales, which accounted for 56 per cent of the total value. An important example is the French government's decision to auction off the three main operators of the highway system for €15bn.

With state-owned assets of approximately €700bn privatised in Europe over the last 30 years, the key question is: how much is left? According to the website Privatization Barometer EU governments still hold direct and indirect stakes worth almost €300bn, mostly in France, Germany and Italy. However, the actual privatisation potential is substantially larger if one takes into account wholly-owned state enterprises as well as public infrastructure.

With more and more capital to manage, the talents and resources of general partners have been stretched to breaking point

As far as the buy-out market is concerned, about 6,300 European and US companies have a value of more than $500m. Of these, 3,600 are based in the US and 2,700 in Europe. More than half appear to be unsuited to private equity because their performance or public ownership structure makes them difficult to acquire. However, research by McKinsey, the management consultancy, suggests that the remainder is still big enough to provide the private equity industry with plenty of growth.

On the supply side, recent survey evidence, such as the Alternative Investing Survey published by Russell Research, indicates that European and especially Japanese pension funds and insurance companies actually plan to continue to play catch-up and increase their exposure towards US levels over the coming years. US institutional investors currently allocate around 7.5 per cent of their assets under management to private equity, but in Europe and Japan that share (including committed capital) is only 4 and 2.5 per cent respectively.

Considerably more supply of capital is also expected from high net worth individuals and through publicly-listed vehicles. The recent, heavily oversubscribed, flotation of an investment vehicle on the Euronext exchange by Kohlberg Kravis Roberts, has attracted a particularly high level of market attention.

Obstacles to high performance

Some studies suggest that private equity outperforms comparable public market investments, others find that historically the broad private equity market has actually underperformed, with only the top general partners consistently exceeding public market returns. As more money flows into private equity, the challenge is increasing, owing to the following three mechanisms.

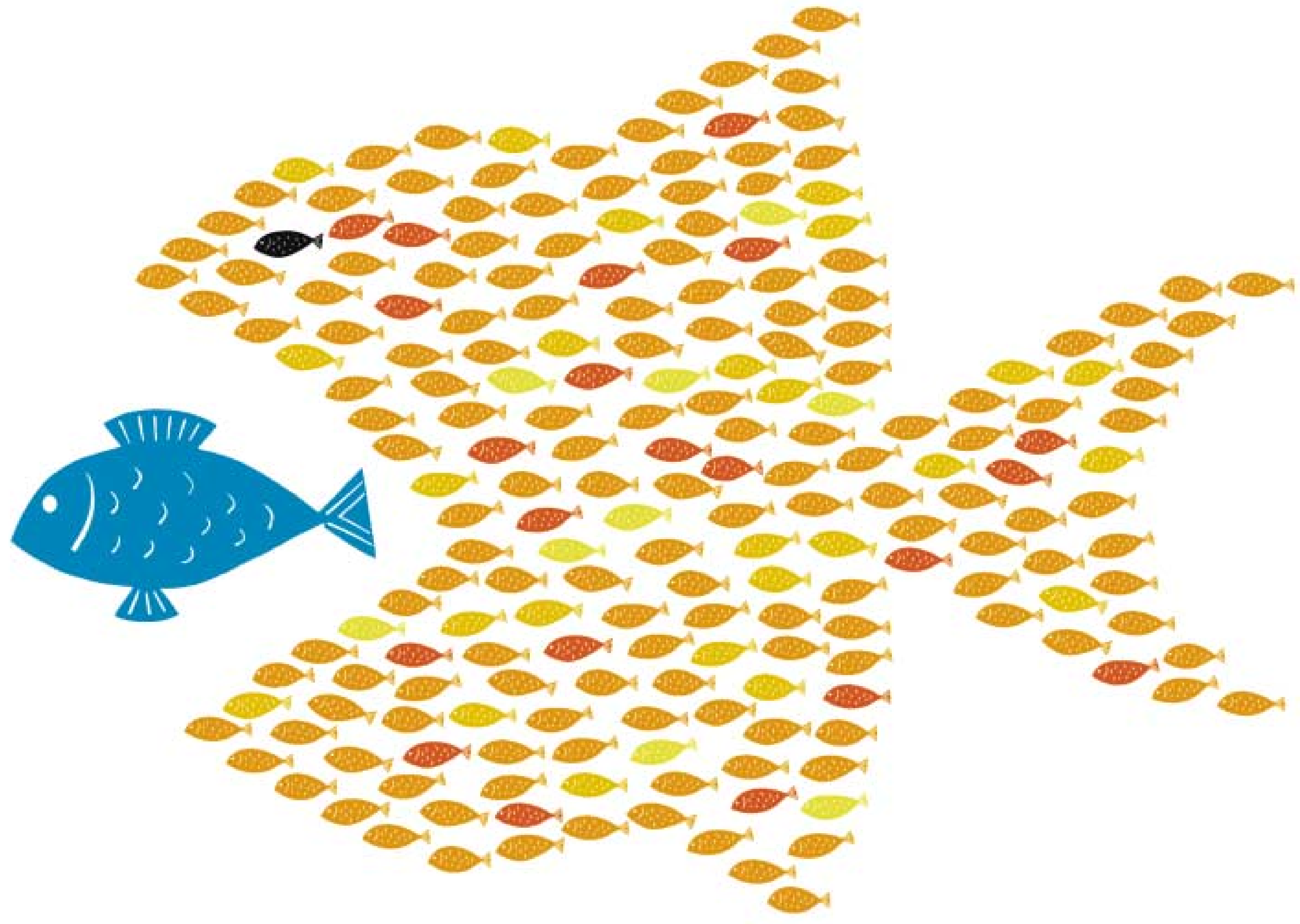
■ **Substantial capital flows to private equity can be self-defeating in the sense that too much money is chasing too few deals.** This problem was identified by Professors Paul A Gompers and Josh Lerner of Harvard Business School, who found that the greater the supply of private equity capital to a fund, the higher the prices paid for the acquired companies. Subsequent research has confirmed that this effect does indeed lower the returns to private equity investment, with asymmetric information between buyers and sellers and herd behaviour amplifying fundraising and investment cycles. In other words, the amount of attractive investment opportunities is finite and, at some point, capital will flow into less attractive investments.

The recent surge in entry prices has been interpreted by some market participants as a sign of this "money-chasing-deal" phenomenon. According to the LCD Loan Review, published by US rating agency Standard & Poors, European buy-outs have become particularly expensive, with average multiples reaching 8.3 times earnings before interest, tax, depreciation and amortisation in 2005, up from a multiple of 6.8 in 2003. However, profit growth and cash flows of underlying portfolio companies have remained strong. And, encouragingly, average debt-to-equity ratios have increased relatively moderately, despite highly liquid debt markets and historically low interest rates.

■ **Excessive growth in fund size from one fund generation to the next can have a significant detrimental effect on subsequent performance.** As investors have grown to appreciate how important it is for their general partner's performance to be in the "top quartile" of the market, more and more money has flowed to general partners with a superior track record. This has raised the question of whether a private equity group able to invest a $250m fund successfully over the past few years will be able to invest a $1.5bn fund with equal success, using essentially the same team.

While a general partner's reputation and track record is a key determinant of his ability to raise subsequent – and larger – funds, research by Professors Gottschalg and Zollo suggests that investors should assess carefully whether a private equity house trying to increase the size of its fund has the skills and resources needed to successfully invest the larger amount of money.

■ **Increased capital inflows to private equity reduce the ability of the industry to shed underperforming fund managers.** If institutional investors find it difficult to meet their target allocation to private equity with high-quality fund managers, some of them may be tempted to commit to fund managers with a less convincing track record. To the extent that this effect keeps less capable fund managers in business and that these continue to make poorly performing deals, it further decreases the average returns to the asset class and could cause reputational damage.



Nick Lowndes

This effect may be compounded if less skilled fund managers help inflate acquisition multiples. As the variance of returns across individual investments and fund managers could increase further, the successful selection of the funds that perform in the highest quartile becomes even more vital.

The private equity community has begun to recognise these challenges. For example, investors are increasingly searching worldwide for opportunities, as evidenced by the sharp rise in cross-border investment flows. Several US private equity houses have opened offices in Europe and some of them have been involved in top European buy-outs, such as TDC and Legrand in the UK, and Eircom Fixed Line in Ireland. `

While the penetration of the US market by European players has yet to reach the same momentum, general partners on both sides of the Atlantic have begun to look to Asia. Meanwhile, in the more mature markets, which are becoming increasingly competitive, private equity houses are pooling their funds to make "club deal" mega-investments.

Performance drivers and incentives

While globalised investment strategies might help sustain returns amid progressively larger allocations to private equity, they are unlikely to be sufficient in and of themselves. More fundamental changes in the mechanisms through which private equity generates value are required and have already begun, especially in the buy-out segment. Historically, a large part of overall buy-out value creation has been coming from factors that had little to do with the actual performance of the underlying business. Examples include financial arbitrage, as investors were able to acquire businesses from their previous owners for less than they were worth, or the tax shielding effect of the large amount of debt that was used in the transaction.

In the more mature private equity markets, funds are pooling their resources to make mega-investments

However, the increasingly competitive market for corporate control and changes in the institutional environment have lowered the ability of buy-out investors to benefit from these effects. Instead, increasing emphasis lies on improvements in the fundamental performance of the underlying business, and the ability of the investing buy-out company to contribute to such improvements.

In doing so, buy-out groups rely on two principal mechanisms. The first is aimed at increasing the motivation of the employees and managers of the acquired business to realise the full performance potential of their operations. To this end, buy-out groups put in place a number of processes that reduce the agency conflict between equity investors and managers of the acquired companies. These include the reduction of available free cash flow due to increased debt service requirements after a leveraged buy-out, as well as employee bonus plans or top management equity shares that align the incentives of managers and owners.

As majority shareholders, buy-out fund investment managers can always intervene or even replace underperforming managers. But recent research by Prof Gottschalg shows that managerial motivation can be enhanced through non-financial mechanisms after a buy-out and that this type of motivation is a particularly important determinant of buy-out success. One key driver of such motivation stems from the fact that managers of acquired companies may not only take financial but also emotional ownership of the companies they manage, which pushes them to do everything they can to make "their" buy-out a success.

The second mechanism comes from the more direct involvement of the acquiring buy-out group in the transaction. A recent Insead study shows that an active involvement of buy-out fund managers in financial, strategic and operational decisions of the acquired business is an important determinant of buy-out value creation, especially if the acquired unit was underperforming prior to the buy-out and buy-out fund managers have the necessary experience to effectively advise the portfolio company management. Other research confirms that buy-outs lead to substantial improvements in the operating performance of the acquired entity, which manifests itself, among other things, in better working capital management and better utilisation of resources. Importantly, some of these improvements persist even after the buy-out group re-sells the business.

While both mechanisms for value creation have now taken centre stage in the management philosophy of private equity investment, they rely on the potential for the stand-alone optimisation of the acquired business. However, such an approach neglects potential synergistic benefits among portfolio companies. This results in a competitive disadvantage with industrial buyers whose strategic focus on enhancing returns through cost and revenue synergies has allowed them to outbid private equity competitors in a number of recent deals.

Some private equity investors have begun to recognise the potential opportunities a shift from a stand-alone approach towards a more portfolio-oriented one may bring about. A number of them have become increasingly industry-focused, and there are several examples where companies bought by private equity houses have made subsequent acquisitions.

Nevertheless, for the industry as a whole, adopting a new model where value is created through portfolio synergies will require a fundamental change in mindset. This is part of private equity's biggest challenge: finding new ways to enhance the fundamental performance of its portfolio companies in a way that makes it possible to profitably invest increasing amounts of capital.

PETER CORNELIUS is visiting professor at the Vlerick Leuven Gent Management School and is an economist with AlpInvest Partners.
Peter.Cornelius@alpinvest.com
OLIVER GOTTSCHALG is assistant professor at HEC and co-ordinator of the Buyout Research Program at Insead.
gottschalg@hec.fr
MAURIZIO ZOLLO is associate professor at Insead, and the Shell Fellow of Business and the Environment.
maurizio.zollo@insead.edu
The working papers of the studies mentioned in this article are available at ***www.buyoutresearch.org***