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Private equity: from “alternative” to “mainstream” asset class?



Executive summary

Every day one reads about the latest private equity threat to a corporate icon. Some lament these threats, while others rejoice that at last an independent force has come in to shake up some lazy corporate assets. Private equity has been around for decades. However, in the years before the 2008 financial crisis, private equity funds gained the power to take on virtually any corporate target they chose. Some became household names—Kohlberg Kravis Roberts & Co. (KKR), Carlyle, and Blackstone from the US, Apax, Permira and CVC in Europe—just the most glamorous among the thousands of private equity funds in operation around the world. The trillion-dollar industry was bound to make some waves when it jumped into the corporate pool...

Whilst the basic principles of private equity have been around for a long time, the explosive growth of the industry is a relatively recent phenomenon. And with size comes a comprehensive “coming of age”, including a broader geographic coverage. While the US remains by far the largest market, some Asian markets are gaining in popularity, with their share in global fundraising expected to reach 20% soon.

As deal size increased, the very large transactions caught the attention of the media, politicians and regulators. Inconsiderate compensations started to generate popular resentment and attempts at regulation in many countries. The tax treatment of the general partners’ carries received a lot of attention, with their capital gains status questioned in face of the limited capital exposure by fund GPs. The use of tax-advantaged jurisdictions for the funds and special purpose vehicles for the deals fuelled the suspicion that private equity managers considered themselves somewhat exempt from greater social responsibilities, at a time when everyone was being asked to tighten their belt. A general move towards more transparency in all aspects of the financial world also put pressure on private equity to provide more disclosure.

All these signs in effect indicate an asset class that is slowly graduating to the mainstream and can no longer pretend to be “different”.

Like many of man's greatest inventions, such as dynamite, private equity can make a great contribution to an investor's portfolio when the basic investment rules are properly applied, and can turn into a rather explosive nightmare if put to uncontrolled use. In other words, private equity can be at the same time the best and the worst the world of assets can offer...

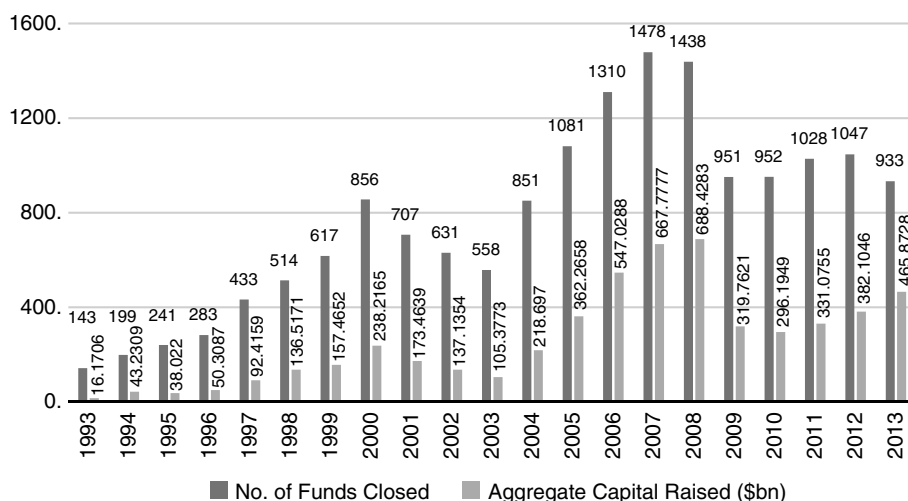
"Private equity" earned part of its alternative credentials because of its cherished confidentiality and privacy. As one of the most exclusive clubs, where price of admission into the best partnerships runs easily in excess of \$25 million, with few if any regulatory authorities to report to until very recently, the industry was keen to maintain an aura of secrecy that helped its cause and reputation. Data on performance, strategies and mechanisms of value creation were hard to find and equally hard to assess since most stemmed from self-reporting to industry trade groups. Academic studies abound but suffer from the same shortcomings, mainly the inability to access comprehensive, unbiased data about funds and investments, especially on their performance.

The press in general also had its gripes about the industry. It shunned institutionalized private equity, preferring to spotlight VC-backed entrepreneurs and their more visible value creation and life-changing innovations. But the sheer magnitude of the industry and its deep penetration in the economic activity of countries makes it impossible for private equity to be ignored.

Moving into mainstream

Private equity has always been classified as an "alternative" asset class, i.e. a loosely defined class of asset which includes all assets beyond the three primary classes—stocks, bonds and cash. In the world of finance, alternative assets may include special physical assets, such as natural resources or real estate; special methods of investing, such as hedge funds or private equity; and even in some cases geographic regions, such as emerging markets. Private equity usually covers investments in companies not quoted on a stock market, i.e. private companies, or sometimes divisions of larger groups, or even investments in listed companies with private capital using a creative combination of equity and debt. Freed from financial and corporate constraints, properly refinanced and equipped with a strongly incentivized and focused management team, these businesses would possibly shine and deliver strong performances. The private equity owners would then sell the company to a corporate rival or take it public, hopefully with great riches for all at the end.

Until a few decades ago, private equity was a small, dark corner of the financial markets that few people had heard of and even fewer cared about. But the recent growth of the industry—before the debt crisis hit in 2008—has been extraordinary, whether measured by the capital raised or the number of funds on the market, as seen below in **Exhibit 1.1**.

Exhibit 1.1 Annual private equity fundraising

Source: Preqin

This extraordinary growth, according to many observers, makes the label “alternative” not appropriate anymore. In its introduction to the *2007–08 Survey on Alternative Investments*, Russell Investments illustrated the new status:

“As interest in alternative investments has grown, and as such investments have become more mainstream, the phrase ‘alternative investments’ itself is beginning to sound like a contradiction in terms. What were once considered fringe investments are now deemed essential components of many institutional investors’ portfolios.”¹

Large institutional investors—such as insurance companies, university endowments, pension funds and sovereign funds—have for the most part adopted private equity as a significant component of their portfolio, playing a leading role in the almost \$3.2 trillion current assets under management of the entire private equity industry as of June 2012.² For many, the move has been extremely beneficial: California Public Employees’ Retirement System (CalPERS), one of the largest public pension funds, recently reported that, since its inception in 1990 to December 31, 2011, its private equity programme has generated \$20.2 billion

¹ The 2007–2008 Russell Investments Survey on Alternative Investments.

² Global Private Equity Report, Preqin, 2013. Estimate as of June 2012. This estimate does not include committed capital that has yet to be called up by fund managers. It is calculated using the sum of the remaining value of portfolios of private equity funds that have reached a final close (excluding funds-of-funds, secondary funds, real estate funds and infrastructure funds).

in profits.³ Private equity is also a significant driver of returns for endowments, the most documented of which is probably the Yale Endowment Fund. In its 2013 report, the Yale Endowment Fund claimed its private equity investment programme has earned a 29.9% annualized return since inception in 1973.⁴ The University's target allocation to private equity, at 31% of assets (June 2013 target), far exceeds the 9.5% actual allocation of the average educational institution, and is expected by the school to generate real returns of 10.5% with a risk of 26.8%.⁵

Private equity has clearly performed well for some investors but not for all, an issue that will be extensively covered in the coming chapters. One thing is clear though: private equity has slowly emerged as a mainstream asset class, one that is bound to affect many areas of the economy. For pension funds in particular, the strong pressure to meet liabilities despite an aging population, increased unemployment and disappointing financial markets has pushed many to increase their allocation to the asset class. And when one considers that the five largest investors in private equity among public pension funds in the US and in Canada together allocated more than \$110 billion (\$25 billion) to private equity in 2012, it is fair to say that a significant share of the general public is indirectly exposed to the asset class, whether it is aware of it or not!^{6,7}

Large sectors of the economy are also directly benefiting from the rise of private equity. The industry, with some 4,800 active private equity firms, employs approximately 89,000 people around the world⁸, while the Private Equity Growth Capital Council (PEGCC), which acts as the US industry lobby group, estimates that the 15,680 US-based private equity-backed companies employ 8.1 million people in the US.⁹ This is not counting the impact on the many service firms, such as consultants, auditors and law firms, that gravitate around the private equity industry.

As the industry graduates from alternative to mainstream, the marketplace is also maturing, developing more specific niches and adopting more complex and focused strategies. Historically, institutional money flowed to primary funds that in turn took equity share in companies. Over time, the industry has witnessed the

³ www.calpers.ca.org.

⁴ The Yale Endowment, 2013.

⁵ Ibid.

⁶ Global Private Equity Report, Preqin, 2013.

⁷ These North American public pension funds are: California Public Employees' Retirement System (CalPERS), CPP Investment Board (Canada), California State Teachers' Retirement System (CalSTRS), Washington State Investment Board and Oregon State Treasury. These European public pension funds are ABP (Netherlands), Keva (Finland), West Midlands Pension Fund (UK), Strathclyde Pension Fund (UK) and AP-Fonden 6 (Sweden).

⁸ Global Private Equity Report, Preqin, 2013. Some of these employees might also work for firms deemed inactive.

⁹ PEGCC website: <http://www.pegcc.org/education/pe-by-the-numbers/>.

emergence of funds-of-funds and secondary funds structured either as primary funds or funds-of-funds themselves. Co-investments by investors alongside their primary fund directly into portfolio companies have become more widespread.¹⁰ Funds are also becoming more specialized, with an increasingly large range of vehicles focused on specific investment stages such as turnarounds, on strategies such as buildups, on geographies such as Europe and on industries such as energy. This maturing of the industry, coupled with recent development in the credit industry as a whole, affects the way the industry functions and performs. These developments will be the subject of the following chapters.

A brief history

The birth of venture capital in the US is generally attributed to General Georges Doriot, a French-born military man who taught industrial management at Harvard Business School. Doriot founded the first modern venture capital firm, American Research & Development (ARD), in 1946 in the belief that when combined with professional management, R&D skills could provide economic growth and capital appreciation.¹¹ At the same time, wealthy families on the East Coast were also setting up their own “venture capital funds”. The Rockefeller fund, which counts Eastern Airlines, one of the first commercial operators, as an early investment, was controlled by the Rockefeller family.

On the other side of the Atlantic, the conditions evolved very differently. Europe was in tatters after World War II and the “European Recovery Program” (which became known as the Marshall Plan) played a fundamental role in rebuilding Europe after the conflicts. The government and business leaders in the UK saw the need for an organization that would provide equity capital for small businesses to help rebuild a dynamic economy. In 1946, under the leadership of William Percy, Investors in Industry was established with £10 million of capital provided by banks.¹² For the next three decades, Investors in Industry (later renamed simply as 3i) was pretty much the UK private equity industry in itself. Progressively, commercial banks started to see the opportunity to invest capital from their balance sheets in opportunities that were generated through their corporate banking networks. For larger amounts of capital, merchant bankers continued to work hard marrying opportunities with their rich clients.

The leveraged buyout, in the sense that it is known today, emerged in the 1980s. In January 1982, a group of investors led by former US Treasury Secretary William Simon acquired card manufacturer Gibson Greetings for

¹⁰ CFA Institute, Global Investment Performance Standards, Exposure Draft, 2010.

¹¹ Ante, S. E., “Creative Capital: George Doriot and the Birth of Venture Capital”. Cambridge (MA): Harvard Business Press, 2008.

¹² 3i.com.

\$80 million, financing a substantial portion of the acquisition with debt. The business was floated 16 months later at a valuation in excess of \$290 million. This marked the start of the first leveraged finance boom, which saw financiers such as Jerome Kohlberg and Henry Kravis, former bankers at Bear Stearns, buying up companies with tiny amounts of equity and huge amounts of debt, much of it raised through the issue of high-yield, or junk, bonds. The 1980s was characterized by the emergence of “easy money”, facilitated by the creation of the high yield debt markets, the brainchild of financier Michael R. Milken, head of Drexel’s high yield and convertible bonds department at Drexel Burnham Lambert.

However, the early 1990s were characterized by the disappearance of an active high yield bond market, prompting private equity players to change tactics. Large leveraged buyouts fell out of fashion. In came the industry consolidations through leveraged buildups or rollups. With the unravelling of junk bond financing and the recession of the early 1990s, private equity went into remission, though one would argue that during that time the industry enjoyed some of its best returns. Activity levels first plummeted, before gradually increasing during the late 1990s and entering a second period of stellar growth.

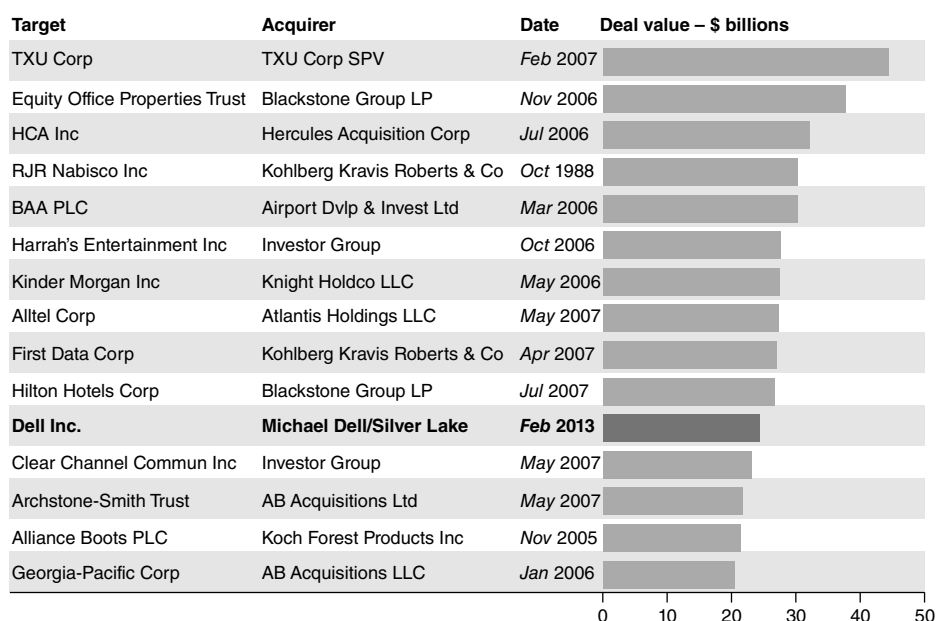
The 2000s benefited from a liquidity surge never seen before. According to research by financial data analysis firm Preqin, the amount raised by private equity firms worldwide increased from \$92 billion in 1997 to \$361 billion in 2005 and a staggering \$664 billion in 2007.¹³ This means that the compound growth rate exceeded 20% per annum over that period. Fuelled by the availability of leverage, buyout deals reached incredible levels during the period. Whereas the aggregate value of buyouts globally was only slightly more than \$100 billion in 2000, it reached some \$294 billion five years later, and \$659 billion in 2007. During that period, first-time funds represented more than one in five funds raised in 2003 and 2004, and more than one in seven for the period 2006–2008.¹⁴ The average private equity fund increased significantly in size, from \$479 million in 2005 to \$598 million in 2006, to \$685 million in 2007 and to an astounding \$770 million in 2008.¹⁵ The growth was fuelled by the combination of easily available debt and solid industry returns, but also in part by the built-in incentives that encouraged fund managers to raise larger and larger funds (see Chapter 2: The Business System).

Funds were not the only entities growing in size: so did the deals. During the decade that led to the financial crisis, buyouts of \$20, \$30 and even \$40 billion were engineered. Eight of the 10 largest buyouts ever done took place between 2005 and 2007, as **Exhibit 1.2** shows.

¹³ Preqin, 2013.

¹⁴ Global Private Equity Report 2010, Bain & Company.

¹⁵ 2010 Global Private Equity Watch, Ernst & Young.

Exhibit 1.2 Largest private equity deals to date (billions)

Source: Thomson Reuters

In this context, it was clear a financial crisis would deeply affect the private equity industry, and fundraising in particular. The sudden unavailability of debt on financial markets hampered deal making, and fundraising for new funds reached record lows. In 2008, fundraising still totalled \$683 billion, but by 2009, that level plunged to \$311 billion, and continued its downward spiral to \$287 billion over the course of 2010, the lowest level since 2004, before slightly increasing to \$312 billion and \$327 billion in 2011 and 2012 respectively.¹⁶ Significant write-downs and delayed exits of portfolio companies affected the performance of funds, many of which exhibited negative returns. By then, investors in private equity were holding back from making new commitments.

As in all prior crises, the industry did recover, adapting to survive and finding new ways to create value for investors.

An increasingly global industry

As the industry evolves and matures, the sources of funds for private equity and their destinations are becoming more diverse. According to estimates by Preqin, North American investors now only account for 56% of all capital currently invested in private equity, while the rest comes from Europe (31%) and to a lesser

¹⁶ Global Private Equity Report, Preqin, 2013.

extent from investors based in Asia (7%) and elsewhere in 2012.¹⁷ Similarly, private equity funds are deployed on a more global basis, with funds focused on North America accounting for only 55% of global commitments in 2011, the rest being deployed equally between funds focused on Europe and those focused on Asia and the rest of the world.¹⁸

There is also evidence that the industry is becoming not only more global but also more globalized. In a study published in 2008, Aizenman and Kendall found that the proportion of deals which are funded with some cross-border participation dramatically increased over time, to reach some 42% of the deals by 2007, before the recession hit.¹⁹ The case study below (see **box** below), one of the many we showcase in the book, illustrates how private equity deals sometimes help reshape whole industries on a global scale. In this specific case, Carlyle transformed the forged ring industry through many cross-border investments.

Case Study 1

Carlyle consolidates the forged ring industry

Carlyle, set up in 1987 with offices and operations in over 20 countries, is one of the largest private equity firms in the world. Its acquisition of forged ring manufacturers is a great story about consolidation of an industry that manufactures one of the most critical components used in aerospace, automotive, power generation and petrochemical industries. The forged ring industry was at the time fairly fragmented, putting it at a disadvantage when negotiating prices with raw material suppliers and its clients, mostly OEM manufacturers, powerful actors in the supply chain.

When Carlyle's Bud Watts and Cam Dyer looked at this picture they saw a huge opportunity. They could bring better management practices to these privately-owned companies which had traditionally been entrepreneurially-run and were for many still managed by their founders. The industry was crying out for consolidation but the players were averse to selling their company to each other. Carlyle—as an independent player—offered a respectable, and well-financed, third-party option to sell out.

When the founders of one such company, FMI, decided to retire and put the company up for sale, Carlyle jumped at the opportunity. A slump in the aerospace industry had caused valuations to tumble, driving the owners to exit the business. The company was well-managed, with low fixed costs and decent

¹⁷ Global Private Equity Report, Preqin, 2013.

¹⁸ Global Private Equity Report, Preqin, 2012.

¹⁹ Aizenman, J. and Kendall, J., "The Internationalization of Venture Capital and Private Equity". NBER Working Paper No. 14344, Issued in September 2008.

margins. Carlyle acquired FMI at a reported price of \$67.8 million. Right after the acquisition, the aerospace industry dived into a deeper recession. In 2002, another engineering company, UK-based Firth Rixson, which manufactured forged cast and rolled components in nickel, titanium and steel alloys, put itself up for sale too. Carlyle figured out that FMI and Firth Rixson together would create a formidable supplier for the aerospace industry. Carlyle's deep understanding of the aerospace industry gave it the means to engineer a successful merger. Initially, the two companies' product lines were overlapping, but over time each facility became a centre of excellence for different sizes, volumes and metallurgical properties, and production efficiency improved.

Soon another investment opportunity appeared on Carlyle's sensitive radar screen: Schlosser Forge. The company manufactured ultra wide rings, a product outside Firth Rixson's competencies. Schlosser Forge was based in California and its ultra wide rings were used in Boeing 777 and Airbus A380 latest generation airplanes. GE Aircraft Engines was its biggest customer, and because it depended on Schlosser Forge, GE was growing concerned with the company's owner getting old. Carlyle believed that Firth Rixson could easily absorb another acquisition, so Schlosser was acquired for \$55 million in 2004. The build-up game plan involved squeezing annual savings through synergies totalling \$5.1 million for a one-time upfront investment of \$2.2 million.

The idea of consolidating the industry and becoming clear market leaders was an opportunity very difficult to resist for Carlyle. Building on the strength of its entities, the new Firth Rixson secured a five-year agreement with GE aviation to supply seamless ring forgings for the GEnx engine. After selling a 36% stake to Lehman Brothers in 2006, Carlyle completed the exit in a secondary sale to Oak Hill Capital Partners in November 2007, generating an aggregate transaction value of nearly \$2 billion, 9.7 times the invested equity. During Carlyle's ownership of Firth Rixson, the company grew to operate 11 facilities across China, Europe and the United States and supplied products to every major aerospace engine manufacturer in the world.

Source: Case study written by the authors and included with permission from the Carlyle Group.

Private equity in North America

Regionally, North America is by far the world's largest and most mature private equity market. In 2007, private equity firms raised an astounding \$353 billion, up from \$96 billion in 1998, for a compound annual growth rate in excess of 15%. Fundraising had peaked earlier in 2000 at \$181 billion, boosted by a significant influx of capital into high technology venture funds, right before the

internet bubble exploded.²⁰ The 2008 financial crisis a few years later dramatically impacted fundraising in North America—merely dividing by two the amount raised between 2008 and 2009—except ironically for firms focused on distressed debt and turnaround investments. The situation slightly improved over 2011 and 2012, although the annual amount raised in the region has never exceeded \$180 billion since 2008, when it peaked at \$630 billion.²¹

The crisis has, however, led to an unprecedented amount of dry powder—capital which has not yet been invested. The majority of global dry powder is held by primarily North America-focused funds, which currently have over \$500 billion available for new investments.²² This dry powder, within the current economic woes in the US (as of August 2014), creates a bit of a paradox. On the one hand, it plays into the hands of private equity firms which have the capital—and the expertise—to step in and turn companies around, positioning them for exit in three-to-five years, when the economy will probably have turned around. On the other hand, the sheer size of the capital pool, and the urgency with which private equity partners are likely to want to put it to work, create upward pressure on deal valuations, in effect antagonizing the very value creation potential of these transactions.

But the industry is clearly getting back on track, after two years of low activity which prevented exits, and in particular private equity-backed IPOs, from happening. According to Dealogic, which tracks IPOs, the largest private equity-backed US IPOs on record have happened after the crisis: HCA, the largest US corporate operator of hospitals and health systems (\$3.8 billion), pipeline and energy transportation firm Kinder Morgan (\$3.3 billion) and media company Nielsen (\$1.9 billion).²³ Moreover, the beginning of 2013 saw the biggest public-to-private transactions since the boom of 2006–2007: the \$24.4 billion Silver Lake-backed privatization of Dell Inc. and the \$28 billion Berkshire Hathaway and 3G Capital-backed buyout of H.J. Heinz Company.²⁴

Private equity in Europe

Europe has also witnessed a huge increase in the scale of its private equity industry over the past decade. By the year 2000, fundraising by European private equity firms was standing at €48 billion, and investments at €35 billion, of which venture capital represented almost €20 billion.²⁵ When the internet bubble exploded, fundraising dropped to €28 billion in 2002, and venture capital investments fell

²⁰ Dow Jones LP Source.

²¹ Global Private Equity Report, Preqin, 2013.

²² Ibid.

²³ *Wall Street Journal*, “HCA: The Biggest PE-Backed IPO Evah, and Other Stats”, March, 10, 2011.

²⁴ Preqin press release, February 20, 2013.

²⁵ EVCA Yearbook 2012.

below €10 billion. Private equity fundraising remained low until a steady influx of capital appeared in 2005, reaching a peak in 2006 at €112 billion.²⁶

The financial crisis crushed the European private equity industry, as it did its US counterparts: in 2009, the total capital raised was only €18 billion and investments €24 billion. Venture capital then amounted to only 16% of all private equity investments. By 2011, the recovery of the industry was under way. In that year, €40 billion were raised and total exit values (at cost) went up. Values of IPO at cost were €3.9 billion for 2011 and €2.6 billion for 2007, and values for trade sales were €11.2 for 2011 and €7 billion for 2007.²⁷

The disparity between European countries was always large: while GPs based in the UK and Ireland represented 43% of all European investments in 2011, those based in France and the Benelux accounted for only 27%, and those in the DACH region (Germany, Austria, Switzerland) for merely 11%. Southern Europe and the Nordic region each represented 8%, while the CEE accounts only for 3%.²⁸ Many European countries have been working hard to create a more private equity-friendly environment. In 2008, France actually replaced Ireland as having the most attractive fiscal and legal environment for private equity deals, highlighting a concerted effort by French policymakers to encourage private equity investment. The UK, which was ranked first in Europe until 2004, dropped out of the top three for the first time, mainly because of changes to the capital gains tax regime.

Private equity in Asia

The share of Asia in global private equity was less than 5% in 2003; it increased steadily in the following years to exceed 10% in 2005, 12% in 2006 and almost 14% in 2008. The amount of funds raised grew at a compound annual rate of close to 24% from 1998 to 2008, before the financial crisis hit the markets.²⁹ Aggregate capital raised for Asia-focused funds now stands at \$47 billion in 2012.³⁰

Because private equity was a relatively new creation in Asia Pacific compared to Europe and the US, it was generally perceived as lacking maturity, offering fewer buyout opportunities and limited exit options. However, the rapid economic growth the region was witnessing made it a tantalizing prospect for private equity investors. Whereas Japan, Australia and New Zealand (commonly referred to as JANZ) dominated the region in 2002, with 66% of Asian private equity fundraising, the trend sharply reversed in the ensuing years, with the rest of Asia (non-JANZ) attracting more than 90% of fundraising by Asia in 2012.³¹

²⁶ EVCA Yearbook 2012.

²⁷ Ibid.

²⁸ Ibid.

²⁹ PricewaterhouseCoopers: Global Private Equity Report 2008.

³⁰ Global Private Equity Report, Prequin, 2013.

³¹ Emerging Markets Private Equity Association, Industry Statistics, 2012.

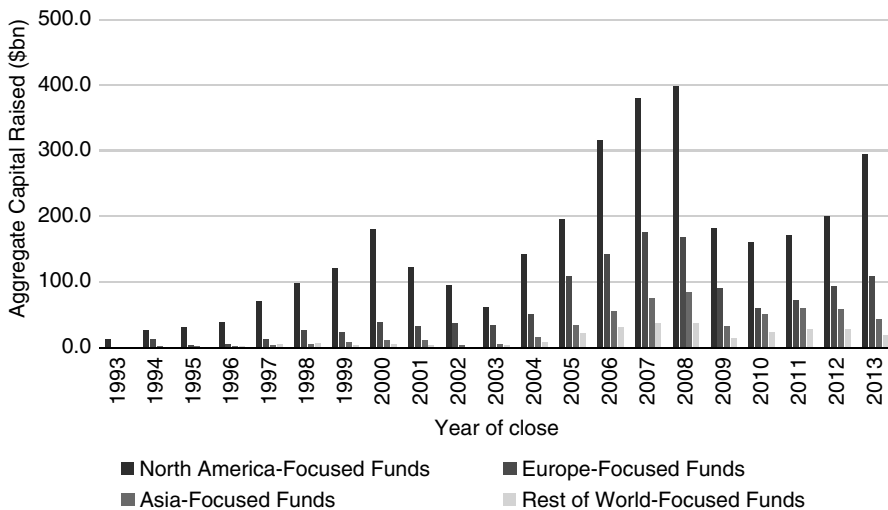
Emerging private equity players

As of mid-2014, the world of private equity is also witnessing the emergence of new players. Many regions outside the US, Western Europe, Japan, Australia and New Zealand are becoming powerful players in private equity. Taken together, emerging markets accounted for about 20% of total funds raised in 2012 and 12% of funds invested, corresponding to \$40 billion and \$24 billion respectively.³²

Of that group, non-JANZ Asia attracted the lion's share, about 60% of emerging markets' funds raised and invested in 2012. The CEE & CIS region attracted about 12% of the funds to emerging markets, while Latin America attracted about 10% (see **Exhibit 1.3**).³³ Overall, funds flowing to emerging markets remain strong, despite a recent notable decrease in funds flowing to China-, India- and Brazil-dedicated vehicles, offset by a recent increase in capital targeting pan-emerging funds and Asia-focused regional funds.³⁴

"We expect to see an increase in private equity fundraising across the emerging markets as investors not only seek exposure to high-growth markets, but also increasingly develop a more nuanced and informed perspective on emerging market risk relative to developed markets," said Sarah Alexander, CEO of the Emerging Markets Private Equity Association (EMPEA).³⁵

Exhibit 1.3 Private equity fundraising by region



Source: Preqin

³² Emerging Markets Private Equity Association, Industry Statistics, 2012.

³³ Ibid.

³⁴ Emerging Markets Private Equity Association, Press Release, February 5, 2013.

³⁵ Emerging Markets Private Equity Association, 2011.

Peter Cornelius, an economist at AlpInvest, one of the largest institutional investors in the world with over €40 billion under management, offered a cautious perspective:

“Economies in Asia and Latin America have gone through massive economic crises in 1998, and again in 2000–2002, which essentially wiped out returns. One could argue that those economies have become more robust, and significantly grown, but I think a number of challenges remain, in part related to coping with governance issues. Going forward, we are cautiously optimistic.”

David Rubenstein, head of the Carlyle Group, pointed to investors’ behaviour during the crises:

“What you have seen in emerging markets this time is different. Western money did not pull out—people saw it as an opportunity to buy at lower prices. It is a sign of the maturation of people investing in these markets.”

Emerging markets have made substantial efforts to attract investors. The exit environment in **China**, for example, has greatly improved; Chinese stock exchanges, including the Hong Kong one, managed to raise three times the amount secured by initial public offerings across the US in 2010.³⁶ According to research conducted by Ergo for the EMPEA, Chinese private equity-backed companies increasingly choose to list on Chinese onshore markets rather than offshore ones because of larger exit multiples.³⁷ In terms of both private equity fundraising and investments, China manages to attract the largest share of total capital for emerging countries, around \$10.8 billion in 2012 (see **Exhibit 1.4**).³⁸

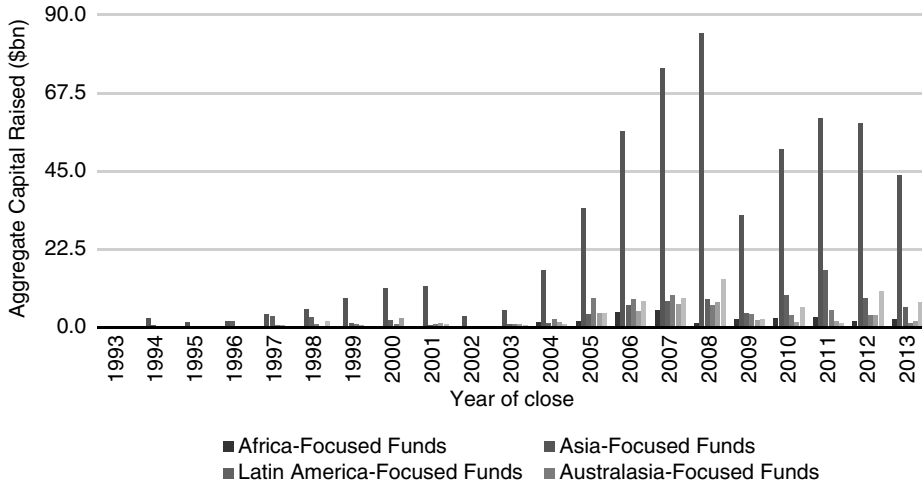
Governance, political risk and regulatory hurdles, however, temper some of the investors’ enthusiasm. An example of the difficulties that could be faced came in November 2008, when TPG Capital was reported by the *Financial Times* to have come unstuck in China.³⁹ In 2007, TPG raised a \$4.2 billion fund for investment in Asia, trumping the \$4 billion fund raised by KKR for the region a few months earlier and, at the time, the largest fund ever raised for Asian investments. In February 2008, TPG took a 60% stake in troubled Japanese leasing firm Nissin Group. Part of the attraction was its subsidiary Nissin Leasing (China), the largest leasing company in China. The deal quickly went sour when TPG became embroiled in a dispute with local management. In

³⁶ *Financial Times*, “Chinese IPOs raise three times US”, December 12, 2010.

³⁷ Ergo, “Exit Via IPO in China, An Examination of the Exit Environment”, December 20, 2010.

³⁸ Emerging Markets Private Equity Association, Industry Statistics, 2012.

³⁹ *Financial Times*, “Tough lessons for TPG China deal”, November 20, 2008.

Exhibit 1.4 Private equity fundraising by emerging markets

Source: Preqin

July 2008 TPG tried to remove management of the Chinese operation, naming Steven Schneider, former Asia Pacific head of General Electric, as the new regional head. When he went to the Shanghai office to deliver the bad news, he and his security guards were chased out of the building. TPG eventually managed to serve the severance notices, but remained embroiled in legal disputes with the former management.

The Chinese government has since encouraged the creation of domestic private equity funds. In parallel, Carlyle, Blackstone, TPG, Morgan Stanley and Goldman Sachs have all recently set up renminbi-denominated private equity funds to raise money directly from Chinese investors and access industries in which foreign investors are prohibited or subject to restrictions, such as media, telecoms, steel and transport.⁴⁰

Case Study 2

Goldman Sachs' investment in Shenzhen Hepalink Pharmaceutical

A noteworthy private equity deal in China is Goldman Sachs' investment in 2007 in Shenzhen Hepalink Pharmaceutical, a small drug company developing Heparin, a blood thinner harvested from pigs' intestines. The company was founded

⁴⁰ *Financial Times*, "Wall St Banks to Launch Renminbi Funds", May 12, 2011.

in 1988 by a Chinese couple Li Li and his wife Li Tan. Goldman Sachs invested \$4.9 million in 2007 to buy a 12.5% stake in the company that has now become the largest supplier of heparin in the world, and the only Chinese producer of finished heparin that is approved by the US Food and Drug Administration. On May 2010, Shenzhen Hepalink Pharmaceutical filed for an IPO on the Shenzhen Stock Exchange. The stock was priced at 73 times its 2009 earnings, making it the most expensive IPO valuation in China at around \$8 billion.⁴¹ Goldman Sachs saw a spectacular 20,000% unrealized return on the \$4.9 million it invested in 2007, and the Chinese couple became China's wealthiest overnight.^{42, 43}

With a business, legal and regulatory environment often seen as closest to the Anglo-Saxon model, **India** has also attracted a large share of emerging markets' private equity, with more than \$2 billion invested in the country in 2012 alone, against \$7.7 billion in 2008.⁴⁴ The country's private equity investments amounted to 0.14% of GDP in 2012, higher than China and Japan (both at 0.08%), but well behind the US and the UK (0.86% and 1.05% respectively).⁴⁵ INSEAD and LGT Capital Partners conducted a study of 335 Chinese and Indian private equity-backed companies who exited between 2001 and 2010, and for which there were entry and exit details. The study made interesting findings.⁴⁶ First, private equity-backed IPOs in India over the last 10 years managed to raise on average a much smaller amount than their Chinese counterparts (\$79 million and \$119 million respectively), whereas average trade sales were similar between both countries. Second, whereas IPOs were the dominant exit channel for Chinese companies with 63% of all exits, they represented only 33% of exits in India. M&A, by contrast, has been the prevailing channel for Indian companies with 67%. The authors put forward a number of reasons for this discrepancy, among which were the difficulty of obtaining controlling stakes in larger Chinese firms and the political and regulatory hurdles that could discourage private sales.

⁴¹ Asian Venture Capital Journal, "Goldman Due 200x Return in China Pharma IPO", April 30, 2010.

⁴² *Financial Times*, "IPO lifts couple to top of China's rich list", April 29, 2010.

⁴³ *Financial Times*, "Hepalink defies China market gloom on debut", May 6, 2010.

⁴⁴ Emerging Markets Private Equity Association, Industry Statistics, 2012.

⁴⁵ Ibid.

⁴⁶ INSEAD Global Private Equity Initiative (GPEI), Study on PE Exits in China and India, 2011.

Case Study 3

Warburg Pincus' investment in Bharti Tele-Ventures

One of India's most noticeable deals was Warburg Pincus' investment in Indian telecoms company Bharti Tele-Ventures from 1999 to 2001. At that time, the telecoms industry was facing major regulatory challenges and the company, founded in 1995 by entrepreneur Sunil Mittal, was acquiring regional licences at bargain prices. US private equity firm Warburg Pincus saw an attractive opportunity and invested around \$290 million over the course of two years in return for a stake of around 20%. In 2002, Bharti Tele-Ventures went public on the Mumbai Stock Exchange to fund the expansion in its cellular, fixed-line, and national long-distance network.⁴⁷ Preparing an exit, Warburg Pincus sold its shares in tranches: first 3.35% for \$204 million in August 2004, then a 6% stake for \$553 million in March 2005 and finally the remaining 5.65% sold to UK-based Vodafone for \$766 million. All in all, the private equity investor generated a 450% return on its original investment, with cumulative proceeds exceeding \$1.83 billion.⁴⁸

Brazil is slowly emerging as a powerhouse in private capital. The Collier Capital survey conducted with the Emerging Markets Private Equity Association in 2011 found that Brazil had displaced China as the most attractive emerging market for investors.⁴⁹ Private equity investment in Brazil had been, however, severely affected by the crisis but rebounded strongly in 2010 when investments more than quadrupled over a year.⁵⁰ Several reasons have been put forward by *The Economist*, among which the maturing of the country's capital markets, the recent change in regulation to allow pension funds to place money more freely with alternative-investment firms and most importantly declining interest rates.⁵¹ Global players like JP Morgan and Blackstone acquired local private equity companies, and Apax Partners recently closed the biggest private equity deal Brazil has ever seen by acquiring a majority stake in **Tivit**, a public Brazilian

⁴⁷ Fang, L. and Leeds, R., Warburg Pincus and Bharti Tele-Ventures, The Global Economic Impact of Private Equity Report 2008.

⁴⁸ Ibid.

⁴⁹ Emerging Markets Private Equity Association and Collier Capital, Emerging Markets Private Equity Survey, 2011.

⁵⁰ Emerging Markets Private Equity Association.

⁵¹ *The Economist*, "The Buys from Brazil", February 17, 2011.

integrated IT application systems and BPO solutions company valued at about \$1 billion.^{52, 53} Brazilian investors are also becoming active global players involved in high-profile international deals, such as the recent acquisition of US fast food giant Burger King for \$3.25 billion by 3G Capital, a US investment group backed by Brazilian investors.⁵⁴

A peculiarity of the Brazilian private equity industry was its lack of reliance on debt financing for its deals. Contrary to the US or Europe, where high leverage was used to increase returns, deals in Brazil often relied entirely on equity.⁵⁵ Debt in fact remained very expensive there—although less expensive than a few years ago—and access to capital was difficult for many companies. If those hurdles were removed, Brazil would greatly improve its standing in the private equity industry.

An industry in the limelight

As the scale of the industry grew, and its influence over large sectors of the economy expanded, so did its profile and the level of public scrutiny vested on it. An early indication of this came on November 25, 2004, when *The Economist* ran a leader under the headline: “The new kings of capitalism”.⁵⁶ The magazine wrote:

“To study firms such as Blackstone is as good a way as any to find out what is going on at the sharp end of capitalism today. Hedge funds may be sexier, at least for now, but it is surely Mr. [Stephen] Schwarzman and his peers in the private equity industry who control the really smart money and wield the lasting influence.”

Few followed *The Economist*’s advice, until the level of scrutiny was taken to a new level as the market peaked in 2007. As private equity firms swooped on household names, such as Alliance Boots (bought for £11 billion by KKR) or Hilton Hotels (bought for \$26 billion by Blackstone), it seemed that no company was too big to be bought by these buccaneering raiders.

Despite the dramatic growth in funds under management until 2007, the scale of the industry was still dwarfed by public markets. In 2006, the value of companies taken private (public companies bought and delisted, usually with private equity backing) hit a record \$150 billion but, even with this peak of activity, the total value of capital raised on world markets outstripped the amounts taken private by more than \$100 billion, according to data from Thomson Financial.⁵⁷

⁵² *Financial Times*, “Apax takes lead stake in Brazil’s Tivit”, May 10, 2010.

⁵³ *Financial Times*, “Buy-out groups rush back to Brazil”, June 28, 2011.

⁵⁴ *Financial Times*, “Burger King approves 3G Capital’s bid”, September 2, 2010.

⁵⁵ Knowledge@Wharton, “Private Equity in Brazil: Entering a New Era”, January 26, 2011.

⁵⁶ *The Economist*, November 25, 2004.

⁵⁷ *Financial Times*, January 1, 2007.

The sudden surge of attention from the press did not fit well with a fiercely private industry. Furthermore, the mainstream media largely took the view that privacy was proof of something to hide. Journalists quickly zoomed in on the outsized bonuses of celebrated private equity executives and the managers of their companies, as well as the level of tax they did—or more pertinently did not—pay. Nick Ferguson, chairman of private equity firm SVG Capital (and former chairman of Schroder Ventures Europe, now Permira, Europe's largest private equity firm), kicked up a storm in January 2007 when he told the *Financial Times*:

*"Any common-sense person would say that a highly paid private equity executive paying less tax than a cleaning lady or other low-paid workers... can't be right."*⁵⁸

Media attention also focused on the activities of the largest funds—also referred to as mega funds—whilst largely ignoring the activities of the vast majority of private equity firms, who continued to buy and support small and medium-sized enterprises (SMEs), an area of activity that has long been supported by governments and policymakers all over the world. There was definitely more glamour in the large deals than in the smaller ones.

The easy money of the 1980s, facilitated by the creation of the high yield debt markets, generated the first very public "bubble" in private equity, culminating in the infamous RJR Nabisco deal by private equity firm Kohlberg Kravis Roberts (KKR) (see **case study** box below). The era came to personify greed and the pursuit of personal wealth at the expense of employees and other stakeholders. Value creation happened through a combination of asset stripping and massive use of high-yield debt, then known as junk bonds.

Case Study 4

Barbarians at the Gate: KKR's buyout of RJR Nabisco

RJR Nabisco, an American conglomerate formed in 1985 by the merger of Nabisco Brands and R.J. Reynolds Tobacco Company, was purchased in 1988 by Kohlberg Kravis Roberts & Co. in what was then the largest leveraged buyout ever. The RJR Nabisco leveraged buyout was, at the time, widely considered to be the pre-eminent example of corporate and executive greed. Bryan Burrough and John Helyar published "Barbarians at the Gate: The Fall of RJR Nabisco", a successful book about the events. The battle for control played out to gasping audiences between October and November 1988. It all started relatively innocuously when

⁵⁸ *Financial Times*, January 4, 2007.

RJR management and Shearson Lehman Hutton, a reputed investment banker, announced that they would take RJR Nabisco private at \$75 per share. That move effectively put the company “in play” and generated offers and counter-offers from anyone that was anybody in the world of private equity, including Morgan Stanley, Goldman Sachs and Salomon Brothers. RJR Nabisco proved to be not only the largest buyout to that date, at \$25 billion (\$31.1 billion, including assumed debt), but also a high water mark and sign of the end of the 1980s buyout boom. The buyout of RJR Nabisco was completed in April 1989 and KKR spent the next few years repaying RJR’s enormous debt load through a series of asset sales and restructuring transactions. The shutdown of the high yield bond market, following the collapse of Drexel Burnham Lambert in February 1990, was the last nail in the coffin of the financial engineering era for buyouts.

The Carlyle Group, ranked by Private Equity International as the largest private equity firm in the world with more than \$97.7 billion under management in 2007, attracted a particularly heavy dose of criticism. Founded in 1987 and still led by David Rubenstein, the Washington-based private equity firm was routinely described by the media as “secretive”—an accusation it deserved no more than any of its peers. The firm’s coterie of advisors, which at various times included luminaries such as former US President George Bush and former UK Prime Minister John Major, raised eyebrows, with some observers arguing that there was something patently wrong with this all-too-obvious link between business and politicians, even if they were former politicians.

Blackstone was also on the receiving end of harsh treatment, particularly over the wealth made by its principals and the firm itself. Stephen Schwarzman, the firm’s founder, was ranked by *Forbes* as the 41st richest person in America in 2007 (falling to #171 in 2010...), and perhaps appropriately his Park Avenue apartment was once owned by John D. Rockefeller, the first US dollar billionaire who was named “The Richest Man in History” by *Fortune* magazine, and allegedly contributed at one point some 1/65th of US GDP.⁵⁹

Headquartered in Fort Worth, TPG Capital (formerly Texas Pacific Group) was founded in 1992 by David Bonderman, James Coulter and William S. Price. It rapidly grew to become one of the largest, most successful and often original private equity firms, making its name with the turnaround of Continental Airlines and a series of high-profile investments, including Ducati (see Chapter 2), Neiman Marcus, Burger King, J. Crew, Lenovo, MGM and a swathe of other household names. Tales of extraordinary wealth abounded, with reports even suggesting that

⁵⁹ *Fortune*, CNNmoney.com, February 2007.

The Rolling Stones were paid \$7 million to play at Mr Bonderman's 60th birthday party in Las Vegas in 2004.⁶⁰

But it was Blackstone's initial public offering (IPO) and associated Securities & Exchange Commission (SEC) filings that lifted the lid on the money being made by the world's premier private equity funds. Blackstone floated in June 2007 in one of the New York Stock Exchange's most talked about IPOs, raising \$4.1 billion and valuing the investment company at around \$38 billion. The firm detailed fund management fees of \$852 million and advisory fees of \$257 million in 2006⁶¹, while media reports picked up on other "perks" received by management, including more than \$1.5 million paid to Mr Schwarzman in 2006 for the use of a private jet that he owned and maintained.⁶² Mr Schwarzman pocketed \$677 million from the listing, but retained a 23% stake in the firm, worth around \$10 billion at the time of the filing.

These numbers were honey to the ears of politicians eager to find a popular cause to fight for in the eyes of potential voters. In April 2005, Franz Müntefering, chairman of the Social Democratic Party of Germany, gave a wide-ranging speech criticizing the market economy and accusing private equity firms of being "locusts", a comment quickly picked up around the world.⁶³ Mr Müntefering was not alone in voicing scepticism about the role and possible lack of contribution of the industry to the economy. A common grievance was the alleged destruction of local jobs, through aggressive restructurings and massive delocalization to lower costs, even though a recent study by the World Economic Forum had reached mixed results on this front, concluding that the evidence supported "*neither the apocalyptic claims of extensive job destruction nor arguments that private equity funds create large amounts of domestic employment*".⁶⁴

Less popular were studies looking at the positive role private equity could play in the economy, especially when compared to public equity. Anecdotal evidence was more widespread, such as the comments attributed to Ian Smith, the former CEO of Taylor Woodrow, a FTSE 100 UK house-builder. Mr Wilson, in a prior life, was also the CEO of hospital group General Healthcare between 2003 and 2006, when it was owned by European private equity firm BC Partners. The firm was sold in 2006 for £2.35 billion to a consortium led by South African hospital group Netcare. This gave him the ability to compare the private and the public equity markets.

⁶⁰ The Forbes 400, 2007.

⁶¹ Securities & Exchange Commission, Form S1, Filed: March 22, 2007.

⁶² Reuters, March 22, 2007.

⁶³ *Time*, May 15, 2005.

⁶⁴ World Economic Forum, "The Global Economic Impact of Private Equity Report 2010."

"The attention on private equity is, at best, misplaced, and, at worst, a bandwagon that irresponsible politicians and union leaders are trying to exploit. The bigger problems are in the public company world, where shareholders are for the most not very good and take up a lot of management's time with diverse and inconsistent demands. I contrast this with the private equity world where investors are extremely well informed about the business, have a singleness of purpose and have their interests aligned with management."

But politicians did not see it that way. After private equity buyers bought or targeted such famous names as Boot's, the AA, Marks & Spencer and J Sainsbury in the UK, scrutiny was inevitable. In March 2007, the House of Commons Treasury Select Committee launched an enquiry into the role of private equity in the UK: *"The scale and significance of the industry is now huge,"* John McFall, the combative Labour MP who chaired the committee, said at the publication of an inconclusive interim report in July 2007. *"It is absolutely critical that we ensure transparency and accountability"* Treasury Committee, Tenth Report: Private Equity (HC 567-I), July 30, 2007.



Increased transparency and accountability became the centre of discussions in 2009 and 2010, when the AIFM Directive and the Volker Rule were fiercely debated in Europe and the US. The industry organized itself to rebut attacks. The Private Equity Growth Capital Council, the buyout industry's lobbying group, was established in 2007 in the US to "develop, analyze and distribute information about the private equity and growth capital investment industry and its contributions to the national and global economy". EVCA plays the same role in Europe.

Mitt Romney's run for President in the US 2012 presidential campaign did nothing to reduce attacks. On the contrary, scrutiny has increased considerably, shedding light on the few disastrous deals the industry has produced and their consequences on employment. With hindsight, it can be justly argued that the worst excesses of the subprime crisis cannot be laid at the door of private equity firms, where the opportunity to make serious money only comes over the long term. Private equity is often criticized for a relative short-term perspective, with a typical investment horizon of three to five years, though many in the industry argue this is longer than in the public company environment, with its demands for quarterly reporting and focus on earnings targets.

Jonathan Russell, chairman of EVCA in 2008–2009 and head of buyouts at 3i, the London-listed private equity firm, said:

"Today, private equity is seen by some as the monster under the bed. The next few years will be crucial in determining the future of the industry and the environment in which we operate. Private equity must stand up and show that it is a force for good in the economy."

