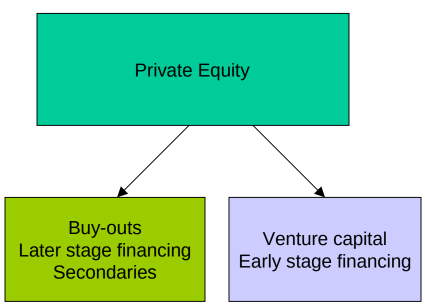
Private Equity

Capitalism’s new kings?

what is private equity?

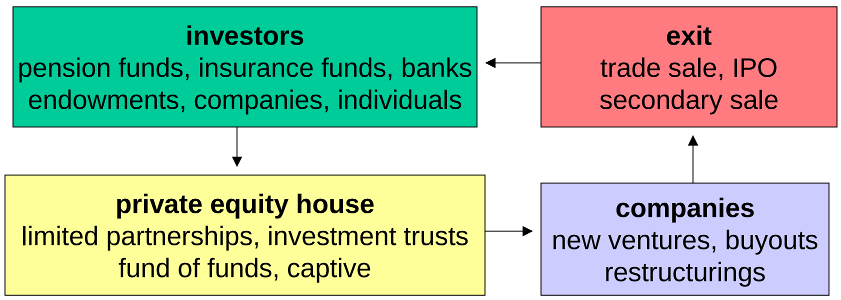


Public equity
Stock market listed companies

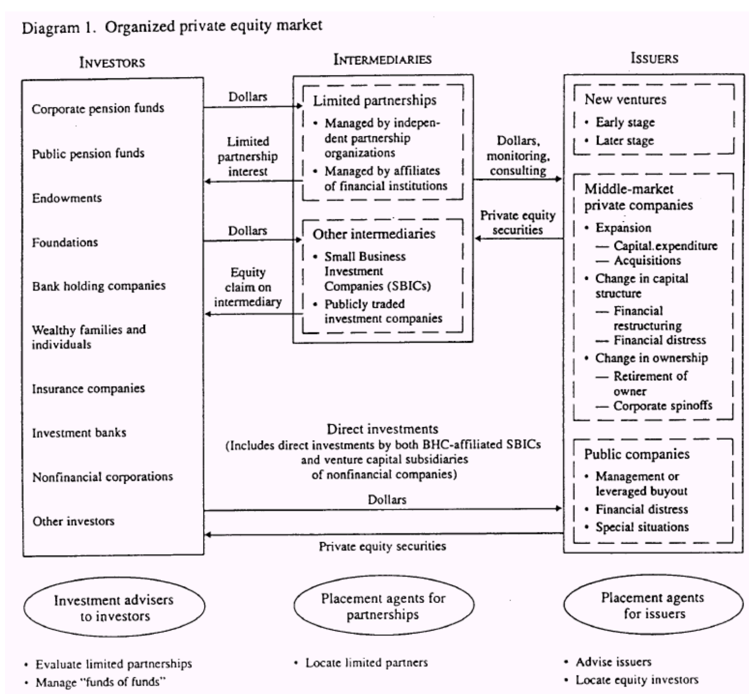
Private equity is illiquid, ownership is concentrated, valuation is difficult, intermediaries tend to be small, finance is accompanied by control and mentoring

Public equity is liquid, ownership is dispersed, valuation is relatively easy, intermediaries are large, finance is often divorced from control and mentoring

the investment cycle



Private language:
there is lots of rather specialised language associated with private equity: general partners, limited partners, committed capital, draw downs, gatekeepers, carried interest, vintages, hurdle rate, co-investment, fund-of-funds, follow-on-fund …



KKR

The Blackstone Group

THE CARLYLE GROUP

Texas Pacific Group

BainCapital

CVC Capital Partners

WARBURG PINCUS

Apax PARTNERS

TerraFIRMA CAPITAL PARTNERS

Advent International GLOBAL PRIVATE EQUITY

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KP CB Kleiner Perkins Caufield & Byers

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TEACHERS' PENSION PLAN

CERBERUS CAPITAL MANAGEMENT, L.P.

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TDC Come closer

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Thames Water

BURGER KING HAVE IT YOUR WAY®

TOYS"R"US

what role does private equity play?

- PE is a key source of finance for early-stage firms and firms that are restructuring
- PE can drive growth
  - a recent report estimates that 2.8m people – or 19% of the UK private sector workforce – are employed by companies that have received PE funding in the last 7 years
  - …and that their 5 year employment growth has been 5 times that of large quoted companies
  - PE can play a key role in the transformation of companies
- but what are the sources of value added? What advantages does private equity have over public equity?
  - superior governance – with focus on true governance that creates value rather than compliance with codes (and lawsuit avoidance)
  - optimal financial and tax structures
  - extremely sharp incentives for all parties – those in the PE firm and the managers
  - smart people and ideas

how big is the sector?

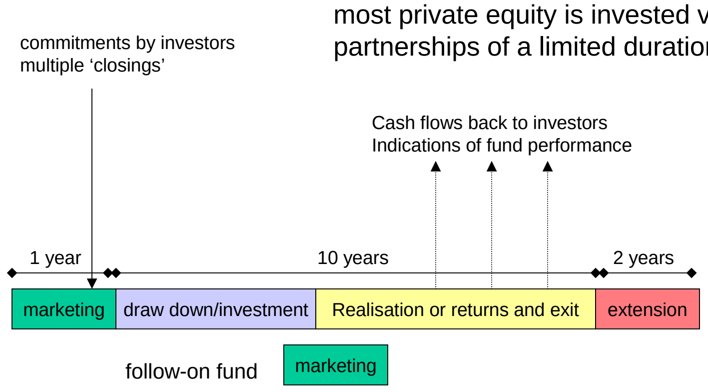
- cumulative fundraising from 98-04 estimated at $1000 billion – 2005 fundraising $111 bn for US, and a record $93 bn for Europe
- historically, US has represented about two-thirds
- Europe represents about one-quarter; not much left for the rest of the world, but some signs that the focus is spreading East
- this is just the equity, buy-outs use lots of debt
- funds are getting bigger: Blackstone has raised a $20 bn fund; TPG has raised $15 bn; KKR has raised $16.5 bn and is still open for more; Permira raised €11 bn; CVC raised $6 bn last year and has just raised a $4 billion ‘tandem fund” ….
- it is currently estimated that $250 billion dollars of equity has been raised that has not yet been invested
- secondary deals are on the rise: in 2005, 28% of all buy-out deals were between PE houses, amounting to over $100 billion (Dealogic)

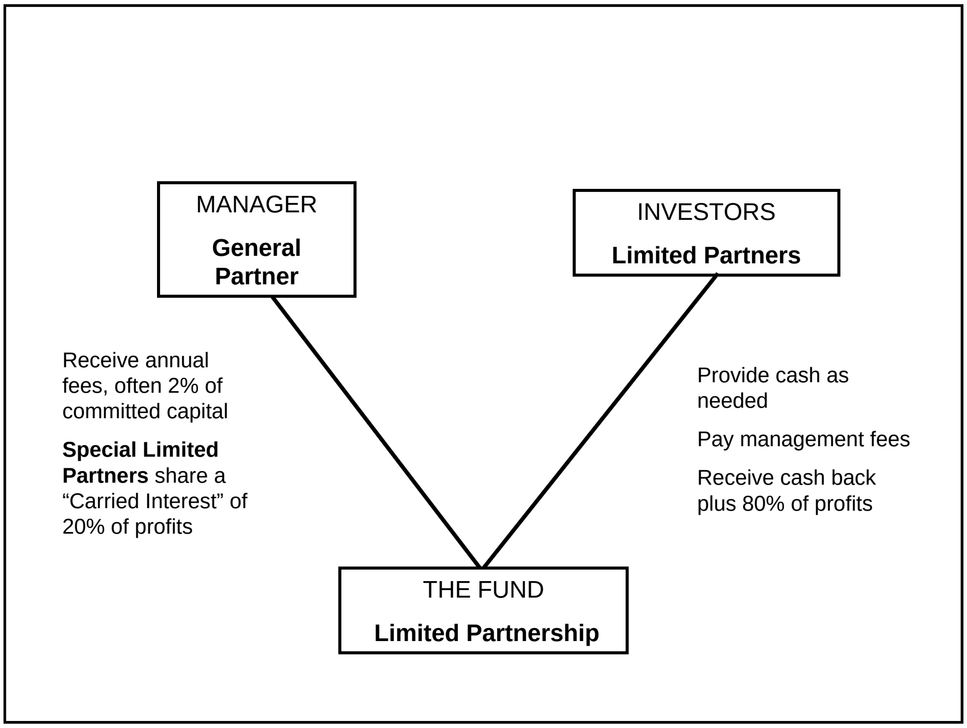
buy-outs are the majority

- about two-thirds of the equity raised for PE is devoted to buy-outs (in both Europe and US)
- but these are highly leveraged – often with only 30% equity in capital structure; so the value of transactions is much larger than the equity figures suggest
- valuations and leverage are extremely high at the moment
- deals are getting bigger: US hospitals group HCA was acquired in November for $33 billion in a club deal by Bain Capital, KKR & Merrill Lynch PE. This was the largest ever buy-out until ….
- Blackstone agreed to acquire Chicago-based office building manager Equity Office Properties Trust for $36 billion in late November. This is more of a real estate deal, but shows that the big PE groups are diversifying across the range of alternative asset classes
- the largest EU deal to date is TDC, bought this year for €13 billion

how are funds structured?

most private equity is invested via partnerships of a limited duration





fees and performance measures

- annual fees at 2% of committed capital
  - varies from 1% to 3%
  - large buy-out funds are closer to 1.5%
  - and fees drop after investment period

- "carried interest" usually equal to 20% of profits
  - profits are worked out on the basis of the entire fund; losses are netted against profits
  - but if the fund produces an overall loss, PE fund does not share in the losses
  - there is often a hurdle to jump, such as 8% IRR
  - note that this is a hurdle – once it is jumped, then GP gets 20% of total return (e.g. if IRR = 7% GP gets zero; if IRR = 10%, GP gets 2%)

- investors normally focus on two metrics:
  - IRR
  - x money – sometimes called total value to paid in (TVPI)

Returns – the macro view

Panel A: All Funds					
			multiple of original investment...		
	# funds	IRR	paid out	remaining	TVPI
Early stage	252	0.2%	0.40	0.60	1.00
Development	173	8.2%	0.74	0.68	1.42
Balanced	146	7.9%	0.66	0.59	1.25
All Venture Capital	**571**	**6.0%**	**0.60**	**0.62**	**1.22**
Buyout	**307**	**12.3%**	**0.70**	**0.67**	**1.37**
Generalist	78	8.7%	0.98	0.37	1.35
All Private Equity	***956***	***9.5%***	***0.72***	***0.60***	***1.32***

Panel B: Top Quartile Funds					
			multiple of original investment ...		
	# funds	IRR	paid out	remaining	TVPI
Early stage	65	14.9%	0.93	0.64	1.57
Development	46	18.7%	1.43	0.61	2.04
Balanced	43	21.3%	1.10	0.71	1.81
All Venture Capital	**154**	**18.6%**	**1.13**	**0.66**	**1.79**
Buyout	**84**	**28.7%**	**1.23**	**0.66**	**1.89**
Generalist	17	12.3%	1.00	0.47	1.47
All Private Equity	***255***	***23.3%***	***1.19***	***0.65***	***1.84***

This table presents returns on an annualized pooled basis for European private equity funds over the period 1980-2004.

The remaining unrealised value is as estimated by the private equity fund. The sum of the money paid out and the value still remaining produces the TVPI.

Source: EVCA (2005).

the micro view – individual fund performance

- this data is not so easy to obtain, at least on a consistent basis
- there are some concerns about the macro figures, as there may be serious sample selection biases in the data (“we don’t invest in dogs anymore, so no point in reporting them to you”!)
- there have been battles in the US with public investors in PE being asked to reveal the individual portfolio investments (e.g. University of California, Ohio Workers Pension Fund etc.). So far, not much has been revealed.
- some of the best and most comprehensive fund level data is available from Calpers, which has been a long-term and significant investor in PE – see the handout

the new Kings of Capitalism?

- PE has grown dramatically in recent years: PE now makes an economically significant contribution to economic growth
- private equity will continue to grow, and will play an increasing role in acquisitions, restructurings, and earlier stage investing
  - PE is now viewed as a plum job, and many executives even prefer to work for PE owned portfolio companies
- many investors outside the US currently allocate a very small proportion of their funds to private equity; this is changing
- but history tells us that in periods when capital is plentiful, valuations rise and returns disappoint – so now may not be the best time to be investing