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THE PROBLEM WITH PRIVATE EQUITY

IT'S ALL IN THE NAME

By Darryl Eales

The term 'private equity' is a much misunderstood and oft maligned couplet, and one that undervalues the role the sector plays in the UK and wider global economy. To represent itself as a key supporter and investor for industry, the sector should re-examine two fundamental questions: What is private equity (PE) and what is its role? In the following article, **Darryl Eales**, *Chief Executive of LDC, examines a much changed business landscape and allows Criticaleye to peer into PE's future.*

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The PE industry has shown itself to be resilient, innovative and adaptable, having reinvented itself several times over the past 25 years. In the 1980s, market inefficiency, embryonic legislation and unsophisticated vendors supported the growth of the industry. Following the early 1990s recession, many firms span out of corporate ownership and economic recovery then growth, together with multiple expansion, led to highly attractive returns.

Post 2000, the industry has continued to mature and we have witnessed the twin benefits of financial engineering and operational value add. Growth has been fuelled by excess liquidity, the credit bubble, the era of mega deals and the emergence of new markets.

Following the financial meltdown, the industry has to reinvent itself once again.

Today's vendors are highly sophisticated, so there is less scope for PE to acquire businesses at under value. Instead, and rightly so, PE must drive its returns through looking at the ways it can add significant value post deal, especially in driving top line growth and operational improvement. Increasingly, even for mid market companies, this means looking beyond the shores of the UK. As the PE landscape shifts once again, there is a return to fundamentals. To outperform other asset classes and drive superior performance, PE must be far more strategic and innovative.

WHAT'S IN A NAME?

At heart, PE needs to be demystified. How much is the assessment of risk, let alone PE itself, taught at universities and schools? Even in conventional business schools, is it taught from a practical as well as a theoretical perspective? Moreover, is the concept of risk:reward truly understood?

Of course, the term 'private equity' itself isn't helpful. It is a cloak that does more to encourage than dispel the prefabricated mystique. PE needs a different name to describe what the industry actually does and that is intimately linked to why it exists A better name, for example, might be 'investors in industry' - the original moniker for 3i.

The strategic rationale for PE is straightforward. It takes a long-term professional approach to assessing business risk and adding value through active ownership with a view to selling the business within a finite year period. At its heart, however, PE, especially in the mid-market, backs outstanding management teams. Strategically, we ask questions like "what does the business need to look like 3 years from now?" and "why will the business be attractive to a new owner?" Importantly, PE should also nurture businesses and ensure they continue to prosper post the exit.

However, a common misconception of PE is that it is too short-term in its focus, with both eyes fixed firmly on the exit. At one level this is undoubtedly true, but PE is, arguably, less short-term than a large listed company, which has no fixed exit horizon and typically focuses on quarterly reporting and the stock price. To my mind PE is, in reality, patient capital; it is not about doing individual deals and making a quick buck but rather about building sustainable success through assembly balanced and well constructed portfolios which generate highly attractive low risk returns.

> *The constitution of PE firms will have to change, with broadened skills sets, more operators and more former CEOs of companies who want to become part of it*

Building relationships is vital too but, in practice, the specific business relationship with most management teams, whilst positive and productive, is ultimately finite. Most, however, result in strong friendships.

Also the management teams themselves are not homogenous. Certain teams would be happy to make a quick return from an early sale where others have more ambitious plans for how far they wish to scale the business and create long-term value. It is crucial before investing that management and the PE house are aligned as joint partners with a clear and unequivocal goal congruence.

Essentially, PE invests in management teams and businesses. It seeks to add value and then exit at a significant profit. Hence, the sentiment 'investors in industry' seems a more apt description of the purpose of PE; we grow companies, we create employment, we drive exports and we improve businesses. The challenge ahead lies in more clearly explaining the positive reasons for PE existence rather than primarily focusing on our returns.

Here are six suggestions for how PE might be presented anew:

1. Patient capital and building a diversified portfolio

Certain PE houses may have skewed their portfolio by investing disproportionately in one large transaction. If this is the one that goes wrong, it can compromise either the performance of the firm or even its very existence. Forget individual deals or individual funds, private equity is about portfolio building and creating long-term value.

Part of creating a successful track record is to take a common sense approach to building the overall construct of a portfolio. In this way, when the inevitable errors of judgement are made, there is not a crisis. Moreover, attractive portfolio diversification can be achieved by numerous means, by sector, by geographic region and by deal size.

THE PURPOSE OF PRIVATE EQUITY IS...

Transition It is essential to have access to PE as an organisation goes through its own life cycle, hence providing options to enable ownership transition and strategy shifts

Growth Beyond mere funding, PE must demonstrate that it helps to improve businesses through operational value add and driving top line

Governance and Board Effectiveness PE promotes the highest standard of Governance and improves the quality of Board effectiveness

Employment PE helps create jobs through wealth creation and growth

Exports Medium-sized companies with PE backing are more predisposed to look internationally

Innovation PE looks at different ways to develop the business in order to earn returns for investors and it enables companies to segue from one stage of their development to the next

Freedom The liberating effect of PE involvement on the management teams means businesses are run more creatively, more innovatively and more decisively

Arguably, the future, particularly for the mid-market, may herald a move back towards a more generalist approach to PE. Sector knowledge is undoubtedly helpful, but adopting a narrowing focused sector based approach is predicated on choosing the right sector. Moreover, to me, sector focus and financial models aren't anywhere near as important as asking simple but fundamental questions such as: what are the key characteristics of this deal? Why is this a situation in which PE might make worthwhile returns? How can we add value to accelerate growth? Why is this a good investment rather than just a good business?

PE is all about improving the odds and understanding the probabilities. It requires the combination of common sense and balanced judgement but, even in our supposed areas of expertise, we continue to make mistakes.

For example, traditionally PE has continued to under price the impact of leverage - by taking on more leverage, you're introducing an extra element of risk over and above business risk. Many deals involving high PE returns have been successful on the back of introducing high leverage, but were the collateral implications of taking on more debt really understood?

2. Structure for the long-term

Debt, in the right quantity, is a perfectly legitimate and essential part of business finance, but the business must be appropriately structured. Post 2008, thankfully, transaction structures will be more robust. At one level, this may mean equity returns will decline, as more equity is required to deliver the same level of absolute capital return but, hopefully, businesses will be acquired at more sensible prices and, on a portfolio basis, there will be fewer partial losses or complete failures. From my experience, these latter factors may lead to equity returns actually improving!

Over the past decade, PE houses have been able to raise a huge amount of debt at unsustainably attractive (ie, low) margins. Where a loan was once priced at 1.5% over LIBOR, it is now around 4.5%. This is too aggressive and, as the pendulum swings back, a long-term margin at around 3% is more appropriate.

This may not immediately be seen as good news for management teams, as private equity houses may need higher equity stakes if the equity requirement increases. True, up to a point, but consider that, as transaction structures become more robust, financial risk is reduced and, correspondingly, the chances of ultimate success increase. But should and will PE demand more from investment management teams?

Typically, management are expected to invest a minimum of one year's salary to acquire sweat equity. This approach has tended to be advisor driven whereby the perception has grown that minimising the management investment is a job well done. To my mind, this is back to front – if I were the management, I would want to back myself and invest as much as was required to maximise my equity upside. This would be a welcome shift in the way deals are structured in the years ahead.

Galbraith referred to the 'brevity of financial memory' and I still expect that, once banks return to competing with each other, rates will come under pressure, leverage levels will again rise, and perhaps margins will, once again, fall to unsustainable levels.

The financial crisis has had one important consequence. If £50 million of debt is raised, for example, it now seems that four banks are required. In sharing these deals, each bank has exactly the same risk profile, so the overall financial system is exposed to exactly the same risk in every single bank. With any institution, you need to demonstrate that you're better than your peer group but, if all loans are shared, where's the differentiation?

3. Promote the secondary exit option

Without question, there has been significantly more scrutiny of the reasons for choosing the IPO route. Why would a management team want an IPO in the mid-market? Generally, I believe PE can provide most of the benefits of an IPO... and then some!

A real benefit of PE is the inherent alignment of objectives between management and the PE house which is not always the case in the public arena, where there may be a lack of time alignment between the objectives and motivations of plc management and institutional shareholders. This is why the reason for pursuing an IPO must be crystal clear.

The only misalignment that may occur between management and PE house is timescale. Management may wish to stay beyond the first exit, hence the development of the secondary buyout market.

Secondary buyouts are a legitimate exit route and an essential (and expanding) part of the M&A canvass. They effectively create a private stock market, which is both liquid and efficient. The participants also intimately understand the nature of the market and the asset class. In this market within a market, continuity is preserved as management can realise some cash but, most importantly, can continue to develop and grow the business with a new PE partner.

4. Deeper and longer PE house involvement

Generally, investment hold periods mirror the economic cycle. In a downturn, investments are usually held for longer in order to create the desired returns. More time will be spent driving operational value and repositioning the business. It is also a time to be bold and PE houses will encourage their best management team to consider acquisitions to create scale and take advantage of competitor weakness.

That said, your first exit is generally your best - there's less time for things to go wrong! At the heart of PE post investment management is risk:reward by reference to the original deal. Throughout the life of the investment the risk:reward strategy needs to be constantly re-evaluated; if we exit now, for value X, how will it compare to rolling the dice again? The same analysis holds true for management and is, arguably, more important to them.

PE is both granular and holistic. We invest in a portfolio of individual companies, the combined performance of which produce the overall result for the PE house. Hence, PE houses need to explain both their overall performance and how it has been achieved across their portfolio. The same overall portfolio return can be achieved with vastly different portfolio risk:reward profiles. That's where the industry needs to engage more, to articulate how good PE investors achieve success.

The key relationship is between the PE house and the CEO. The nature of the relationship depends largely on the house and its style. In all circumstances, however, if the triumvirate of the Chairman, the CEO and the PE house works well, then the result will be a great investment.

Communication between the CEO and the PE house is absolutely fundamental. PE houses don't mind hearing good news late – they just don't like surprises. Bad news must be communicated early. If the CEO is dealing with PE for the first time, the coaching role of the chairman is essential. Generally, the deal process itself forges a strong bond between the CEO and the PE house through close proximity and shared experience. After all, by the exit stage, you've been through quite a lot together.

As part of the deepening involvement with portfolio companies, the constitution of PE firms themselves will need to evolve. Already PE houses are developing and expanding their range of skills and, increasingly, I believe a greater number of former CEOs will become part of PE houses' investment teams.

5. Greater collaboration between the GP and LP

The financial crisis has forced a much closer examination of the relationship between the general partner (GP) and the limited partner (LP).

Much attention has focused on the management fee. This is valid as there is a perception that some GPs have achieved disproportionately attractive personal remuneration, outwith the returns they actually achieve on the fund, which drives the return for the LP.

In 2009, when deal activity was generally dormant, some LPs increasingly put GPs under pressure either to invest or return their funds. This may be a driver of the increased activity we have seen in 2010. Looking ahead, PE houses will need to begin to accelerate the exit of companies to prevent portfolio bulge – this augurs well for future investment activity.

> *PE is actually patient capital: not just doing one deal and having a great result, but scoping out the need to do 20 deals to build portfolios and long-term success*

LPs face more challenges in determining their asset allocations between houses. There will be a flight to quality and to houses where the relationship between GP and LP is closest. This is how it should be. This may result in the overall number of PE houses falling, but the market will undoubtedly remain fragmented.

Without question, LPs are going to want to make sure that there is a fair allocation of reward between GP and LP. The 2/20 model has served the industry well, but it's now looking a bit one-dimensional. In the future, it may be necessary to structure the incentive arrangements more creatively.

The range of LPs will also develop. For instance, there are increasing numbers of wealthy individuals that want direct exposure to PE and to be that bit closer to the fund manager. Looking at models like the investor

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network, Pi Capital, you may soon have serious 'investor clubs' with real firepower.

Shareholders are generally getting closer to the operations of the organisations in which they have holdings. The LP is generally a manager of money and an allocator, rather than an operator but, if you attract the wealthy individuals who've made money in business, you've got operators that can also add significant value.

Looking further ahead, how does PE make itself more accessible, as an asset class, to private individuals rather than the super rich or the large institutions. At the lower level, you've already have business angels networks and clubs such as Pi, but is there an equivalent model that could be applied across all of PE or even just within the mid market? This is worthy of more debate.

6. Building Board Capabilities

Board effectiveness is a key element of success. To drive value, it is increasingly necessary to have a much broader set of skills at Board level. Board composition also needs to evolve to reflect the needs of the business and the status of the investment. This is especially true of non-executive appointments.

For example, you may have a non-executive who can add real value at the beginning where the focus is on operational improvement but, when you want to position a business for exit or access new markets, there may be a different knowledge or skill-set required. The role of the PE non-executive director is to add value - tactically, strategically and operationally. Identifying the key skill sets required in the chairman is critical – his or her skills must marry with the needs of the business and compliment the skills of executive management.

There may even be dual representation on the board: non-executives who can add real investment value and non-executives who bring the formal governance to what should be quite a fast-moving board. However, the drive for governance should not be allowed to stifle decisions.

A public debate about the real role of a non-executive director could be intriguing. For example, company law, as currently constituted, articulates no differentiation between executive and non-executive director. But should a non-executive director have exactly the same obligations and liability in law as an executive director?

It could be argued that, in a PE backed company, the Board is more proactive and hence the role of the non-executive is more important to the company. A key issue in all of this is to ensure that the perceived risks of being a non-executive director do not lead to a situation whereby fewer people wish to serve as one. This would be disastrous.

INVESTORS IN INDUSTRY

PE will no longer achieve superior returns by leverage and financial engineering. It must be more creative in finding new ways to drive real value. At the same time, rightly, it will be subject to greater scrutiny in terms of regulation, transparency and communication. This is a natural stage of evolution in a maturing industry.

At the same time, there must be a level playing field. Disclosures for PE backed businesses, for instance, should be equally applicable to any private company and there needs to be a much more balanced debate about what is a fair level of disclosure.

But the PE industry should be bolder in justifying its existence. This requires a major rebranding of 'private equity' to describe better the benefits it brings: enhanced governance, board effectiveness, helping to improve companies, not to mention job creation, promoting exports and supporting growth. It also needs to be more open – perhaps going out into schools and communities to discuss business and risk taking. Creating wealth is critical to the future of the country and PE is at the heart of wealth creation.

PE is a force for good – but it is not perfect. Now is the time for it to rebrand itself and do what it says on the tin... invest in industry.

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Darryl joined LDC in 1987 and has been CEO since 2003. He is the Chairman of LDC's Investment Committee and sits on the Boards of a number of LDC's significant investments.

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