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# Private Equity Success: High Returns in a Risky World

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English 106: Advanced Writing

PRIVATE EQUITY SUCCESS: HIGH RETURNS IN A RISKY WORLD

Ross Corey

ENGL 106: Advanced Writing

September 5th, 2018

## **PRIVATE EQUITY SUCCESS: HIGH RETURNS IN A RISKY WORLD**

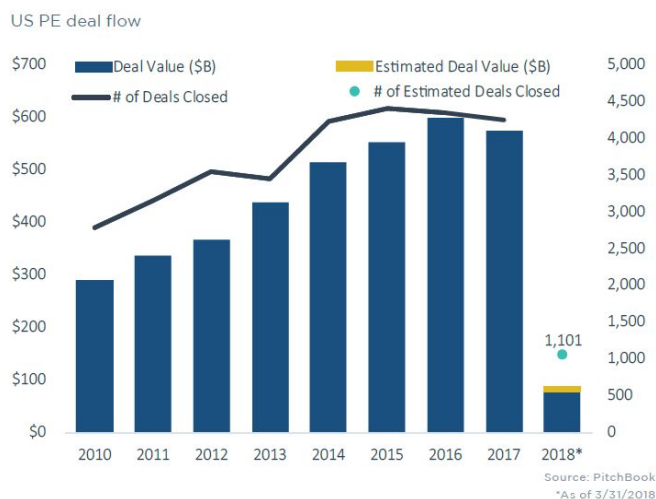
### **Introduction**

One of the worst private equity deals in history was when TPG Capital spent \$7 billion into the savings bank of Washington Mutual. Just after the deal was agreed to, the 2008 financial crisis hit America and the result was ugly. TPG Capital lost the \$7 billion they invested, as well as a \$1.35 million investment in the firm. While luck was a huge factor in this case, this article will explain how firms can attempt to avoid such tragic losses.

Investing in platforms such as stocks, bonds, and real estate may offer good long term returns. A small percentage of people look to invest in private equity markets. A reason for this is because funds have high minimum investments which makes private equity more exclusive compared to many public markets. A private equity investment, in most cases, is an opportunity for higher returns, with the cost being that there is more risk involved. This is not always the case as there are stocks that are much more risky, but compared to the typical personal stock portfolio an individual has, private equity is typically seen as being riskier. Within private equity there are ways a firm can set itself up for a better chance at succeeding in the industry. There are considerations and strategies that firms can implement to increase their chances at generating less risk in their investments without negatively impacting their capital returns. These factors include, but are not limited to, the relationships that the firm builds, the decision making process within the firm, and a firm's ability to analyze the current market. If a private equity firm considers and has a reasonable approach to these components then the firm will be well on its way to achieving the luxuries and success that every firm and investor seeks.

## Background

Figure 1:<sup>1</sup>



First, it should be noted that private equity (PE) as a means of investing has been increasing in the United States since the financial crisis of 2008. Figure one shows a graph of the deal flow of private equity firms in the United States over the last 8 years. Deal flow is the rate in which private equity firms receive deal proposals and investment opportunities. The dollar value on the graph is a variable that is cumulative of all the deals made in that calendar year. There has been a steady increase in the deal flow since 2010, with the exception of 2017. However, 2018 is on track to to beat 2017 in the number of deals closed. If 2018 continues the trend of Q1, there will be approximately 4,400 deals closed, according to the statistics acquired by Pitchbook.<sup>2</sup> While there has been great growth in the private equity deal flow in recent years, private equity, similarly to the public markets, took a huge hit during the financial crisis. However, private equity was affected to a lesser extent. This could be attributed to the nearly \$2 trillion in equity

<sup>1</sup> Lewis, Adam. "9 Charts That Capture The US Private Equity Industry." *Pitchbook* (June 15th, 2018).

<sup>2</sup> Ibid.

that PE groups raised in the years leading up to the financial crisis.<sup>3</sup> Needless to say, private equity has recovered which is noted in Preqin's 2018 reports, which states that as of June 2017 private equity assets are at an all time high — \$2.83 trillion.<sup>4</sup>

### **Leveraged Buyout**

There are many different strategies that private equity firms use in order to make high returns. One unique practice for a private equity firm is to buy a company with funds that are nearly all borrowed, whether this be through debt, or bonds. This is known as a leveraged buyout (LBO). Usually the assets of the company being bought are used as collateral for the loans in addition to the assets of the company being purchased. This investment strategy allows companies to make large acquisitions without having to commit a lot of capital. When considering making a leveraged buyout, one should understand it is a high risk transaction. Here is an example of how an LBO could turn out. A PE firm wants to buy a company but does not have enough cash or assets at the time. In this case, they would use a leveraged buyout so they would have the assets of the target company to secure the necessary funding. Once the acquisition is complete, if the PE firm and the company acquired cannot meet their large debt obligations with the combined cash flow, then they risk bankruptcy and the private equity firm ends up with a huge loss.

### **Firm Strategies and Specialization**

Some private equity firms find that using private debt strategies is a financially beneficial way for them to invest. PE firms use private debt in a few ways that include, direct lending, mezzanine loans, and distressed debt. Direct lending is private lending to companies in the form

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<sup>3</sup> Preqin Inc. Private Equity Reports (2006-2008). ([www.preqin.com](http://www.preqin.com)).

<sup>4</sup> Preqin Inc. "2018 Preqin Global Private Equity & Venture Capital Report." (Sample Pages).

of loans, instead of equity. Mezzanine loans are a way for a business to obtain capital without offering any collateral. If the business does not meet the conditions of the loan, then the lender, the PE firm, can convert its loan into an ownership stake in the company. Private equity firms may also be interested in investing in distressed debt. These are securities that are issued by a company and can be acquired by a private equity firm or someone willing to buy. The investor is buying distressed securities from a company that is experiencing trouble, usually being near or going through bankruptcy. Firms that decide to invest this way consider it worth it because they can purchase the assets at a discount. These investments are risky and would be considered by firms that are more risk seeking. A firm that is more risk averse would not make such investments.

Although direct lending, mezzanine loans, and distressed debt are risky investments, firms are becoming increasingly intrigued by the possibility of achieving high returns this way. In fact, in January of 2018, KKR closed a \$2.24 billion global private credit fund. Daniel Pietrzak, a member of KKR, stated that the firm will “Continue to lean in to this strategy because global capital markets have evolved and created a permanent need for long-term capital providers to support financing activities. Specifically, we see significant opportunities for junior capital in asset-backed financing transactions. In addition, we expect the traditional corporate mezzanine opportunity set to be active in the coming years on the heels of increased M&A (mergers and acquisitions), corporate liquidity and available private equity capital.”<sup>5</sup> Private equity firms are able to utilize the added flexibility that comes with private debt to leverage their relationships with target companies to offer them credit solutions. The last three points that

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<sup>5</sup> Businesswire Press release. “KKR Closes \$2.24 Billion Global Private Credit Fund.” *Business Insider* (January 8th, 2018).

Pietrzak mentions are huge reasons on why KKR closed this massive fund. While private credit transactions are some of the riskier transactions a PE firm can make, higher M&A, corporate liquidity and private equity capital make this kind of investment less risky.

### **Illiquid Risk**

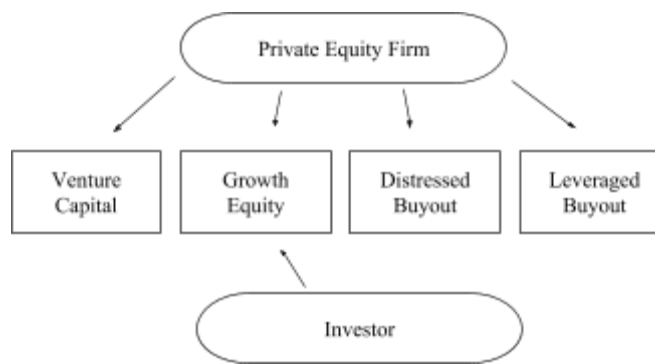
The process of taking over and turning around a company is not quick and what differentiates a private equity investment from other investments is that the equity is illiquid, meaning that you cannot see the value of your investment until it is sold. With the stock market, there are valuations of companies constantly being updated so it is easy to keep track of how your investment is performing. With private equity, it usually takes anywhere from two to six years to turn a company around and during that time there is no updated valuation of the company. This ideal can be unsettling for a lot of investors, but it has been argued that “the drastic reduction in transaction costs of U.S. equities makes illiquidity less of a concern for investors in recent years.”<sup>6</sup> While reduction in transaction costs do help, it is only one variable. An important variable that should be considered is the amount of capital that goes into the acquisition of a company. The more capital that is invested will result in a greater impact that illiquidity will have on a PE firm by increasing the risk factor. This is simply because of the difficulty of valuing the investment. Illiquidity is something that should be considered when making any investment, however, it is a reality that is certainly understood by private equity firms in many of the investments they make.

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<sup>6</sup> Chen, Linda H., et al. "Risk, Illiquidity or Marketability: What Matters for the Discounts on Private Equity Placements?." *Journal Of Banking And Finance* 57, (August 2015): 41-50. EconLit, EBSCOhost.

## Private Equity Fundraising

Figure 2:



Private equity firms use fundraising as a way of gathering capital from investors for their funds. When an investor makes an investment in a certain fund that is managed by the partner in the fund this allows for the investor to benefit from the specific fund in which he or she has invested in within the PE firm. Figure 2 shows this process with a firm that has generalist funds. This means that there are multiple funds that the investor can invest his or her money in. The investor can benefit if the the growth equity fund is chosen, just like he or she can benefit from the other funds. Choosing the fund to invest in within a firm that has generalist funds is all about preference. Some PE firms will have highly specialized funds where the firm will only raise money for a specific asset class. For example, instead of the investor in Figure 2 having four funds to choose from within the firm, they will only have one. If the PE firm is highly specialized in leveraged buyouts, then the investor will only have an option to invest in the leveraged buyout fund. Generalist funds and specialized funds both have the same goal of producing high returns. A study has shown that there is a positive correlation between achieving



high returns and having success in fundraising.<sup>7</sup> Someone will continue to invest in previous funds where their performance expectations were met. Preqin, a firm that gathers data and provides insights, concluded that, in 2017, 95% of investors felt that their private equity investments met or exceeded their expectations.<sup>8</sup> Given this statistic and the relationship between investors meeting their expectations in their investments and fundraising in private equity it can be argued that returning investors are the foundation on which private equity is building. If expectations of investors continue to be met, then private equity will continue to grow at a fast rate. It could perhaps further be argued that private equity firms that meet or exceed their investors expectations could propose an opportunity for exponential growth by the likelihood of investors talking about their success that they have had investing in private equity. However, at this time more data is needed to confirm this speculation.

### **Large Buyouts**

There has been a trend where size of private equity buyouts have become more capital intensive. The global value of private equity buyouts larger than \$1 billion increased from \$28 billion in 2000 to \$501 billion in 2006, according to Dealogic, a firm that tracks acquisitions.<sup>9</sup> This rapid growth can be attributed to the increase in the reputation of private equity firms being able to substantially increase the value of their investments. A major increase in the value of their investments is always seen as a success. It can be concluded that people have become more trusting of more private equity firms, perhaps because of previous returns they have observed the

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<sup>7</sup> Gejadze, Maia, Pierre Giot, and Armin Schwiendacher. "Private equity fundraising and firm specialization." *Quarterly Review Of Economics & Finance* 64, (May 2017): 259-274. *Business Source Complete*, EBSCOhost.

<sup>8</sup> Preqin Inc. "2018 Preqin Global Private Equity & Venture Capital Report." (Sample Pages).

<sup>9</sup> Barber, Felix and Goold, Michael. "The Strategic Secret of Private Equity." *Harvard Business Review* (September 2007).

firms making. When high net worth investors trust private equity firms more, the firms will accumulate enough fundraising money to be able to invest in these massive buyouts. The increase in massive buyout deals can also be attributable to more competition among PE firms as the market becomes more crowded. Regardless of what the reason may be, firms that are making these large buyouts find them attractive despite the added risk that comes with investing more capital.

### **Relationships in Deal Making**

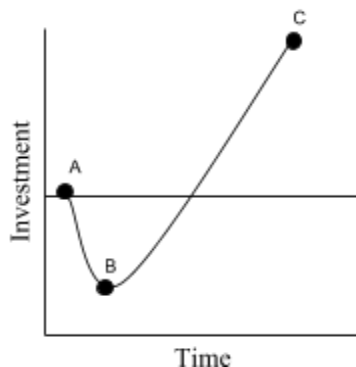
The tricky part for a private equity firm is not necessarily getting a deal, it is how does the firm secure a “good deal.” Brokers and investment bankers are always contacting different private equity firms and letting them know about deals that they should take. Perhaps they make the deal seem specialized to the firm, when in reality they are contacting many firms saying the same thing in order to make a sale. These are not typically good deals, they are just deals. Instead of making deals this way, it is advised to make a proprietary deal.<sup>10</sup> A proprietary deal is when a firm gets an offer before anyone else and this is typically done through a connection that the firm has. Having good relationships with executives within an industry can be helpful to obtain these kinds of good deals. It is also important to have good relationships with other private equity firms because if a PE firm gets a good deal, but does not have all the capital to complete it, they could come to another PE firm to be part of a syndicate. Creating and maintaining relationships as a whole is an important skill and can lead to proprietary deals, which creates a better opportunity for success as a PE firm.

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<sup>10</sup> Balaban, Steve. “6. How Do Private Equity Firms Find Deals?” *YouTube*, (June 7th, 2016).

## Private Equity Process - J Curve

Figure 3:



The J curve is a graphical representation of private equity fund returns over time and is something all PE firms should keep in mind throughout the decision making process. Point A in Figure 3 shows the initial commitment from investors in the private equity firm's fund. In between point A and B is the stage where the private equity firm is looking for deals and the fund is losing money due to management fees. Point B is where the fund starts investing in companies. Then, over time, the private equity fund will exit their investments and as the PE firm continuously exits companies at increasingly higher valuations, the curve in return continues to go up, which creates the "J" shape. In private equity the hard part is taking the time to do analysis, putting together the management team, and going through the beginning stage where the returns are not visible. Eventually, if those areas are successfully completed, then the PE firm will be rewarded.

### Returns of Private Equity Vs. Stock Market

Cambridge Associates, a performance tracking index of private equity firms within the United States, reports that private equity firms gave investors an annualized return of 16% from

2003 to 2013. On the other hand, the S&P 500 returned 7.4%.<sup>11</sup> This shows that during this time period, private equity outperformed the S&P 500 by more than doubling its percentage of returns.

**Figure 4:**



Figure 4 illustrates the comparison between the private equity market and the S&P 500. This graph is the percentage change, assuming the profits are reinvested, which is provided by Preqin. Despite private equity investments being relatively illiquid, Preqin uses quarterly reports of thousands of private equity firms and takes into account their valuations and the money they pull in and the cash returns they pay out.<sup>12</sup> While this graph makes private equity look promising, there is still the boom or bust component to private equity investments. There are investments in companies that will fail and there are investments in companies that will make a significant return. Failure is less common in public markets, and despite what figure 4 shows, this is another reason why private equity investments are usually riskier than investments in the public market.

Why has private equity been able to outperform the stock market? Well, there are many factors, but to list a few, there are huge incentives for the portfolio managers, they use debt to

<sup>11</sup> Davies, Paul. "Does Private Equity Really Beat the Stock Market." *The Wall Street Journal* (February 13th, 2018).

<sup>12</sup> Davies, Paul. "Does Private Equity Really Beat The Stock Market." *The Wall Street Journal*. (February 13th, 2018).

receive financing and tax advantages, being free from the restrictions of public companies, and a major focus on cash flow and improving margins. Felix Barber and Michael Goold of Harvard Business Review speculate that a strategy that combines a combination of business and investment-portfolio management is the core of private equity success.<sup>13</sup> This strategy is often overlooked, but the awareness or lack of awareness in management can potentially lead to the success or failure of a private equity firm.

### **Making the Right Management Decision**

There are recognizable indicators that private equity firms analyze during the decision making process of acquiring a company. One of these indicators is analyzing the management of a firm and coming up with a future plan for the management. Once a firm recognizes this part they can decide what kind of acquisition their firm should do. One of the most common acquisitions a private equity firm pursues is a management buy-out (MBO). This is when existing management continues to run a firm while a private equity firm helps fund the process. There is also a management buy-in (MBI), in this case new management wants to buy out existing shareholders and needs funding from a private equity firm. The private equity firm then decides if they want to do the deal and if they agree, the company will then be run by new management. Private equity firms will also search to seek if a business is underperforming due to management. This is analysis that they do themselves. Perhaps the current management is too hands off or putting the company in the wrong direction. If it is determined that this is so, a private equity firm would consider doing an institutional buy-out (IBO). This is where the private equity firm provides both the financing and the management team. It is important for a

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<sup>13</sup> Barber, Felix and Goold, Michael. "The Strategic Secret of Private Equity." *Harvard Business Review* (September 2007).

private equity firm to recognize if the management needs to be changed or if the current management needs to be incentivised in a way that has the potential for increased performance. In both an MBO and an MBI a public company will need to be taken private in order to execute the changes that are needed to be made. Given this scenario, a private equity firm's implementation skills will be tested and are of the utmost importance.

### **Private Equity Concerns and Considerations**

Although risk management does vary from firm to firm, a PE firm should recognize their tolerance for risk as soon as the firm is established. If a firm wants to minimize the risk of losing capital then the firm will implement a more risk averse approach. It is impossible to be completely risk averse in private equity because an investment is an investment and business does not always go as planned. With that said, there are precautions and considerations a private equity firm can take to minimize the risk of a PE investment. Risk management should not only be seen as a requirement due to an increase in regulation, but it can be seen as the core of operation within a private equity firm. When making decisions, each private equity deal needs to be considered carefully by assessing each company thoroughly. Some of the most important things a PE firm is looking at when acquiring a company is if the company is profitable and to what extent, as well as the potential for the company. Profitability can easily be found by looking at the revenue and total costs a firm has. Determining the potential for a company is more difficult, as it is a prediction. However, the better a firm gets at predicting the potential of a company, the better off the firm will inevitably be.

As noted earlier, investors that work for distressed debt firms are seen as making more aggressive investments for the chance of obtain even higher returns. Mark Hyde, head of

restructuring at law firm Clifford Chance, stated, "If you buy at 20 and recover at 30, you've made a good profit."<sup>14</sup> But what are the concerns in investing this way? The possible downfalls of investing in distressed debt are noted in the article, "Distressed debt investors await new round of defaults" by Arleen Jacobius.<sup>15</sup> It is argued that there are circumstances that can cause the buyout deals and financings bolstered by lower quality debt to tumble. This is linked with a rise in interest rates and a possibility of an economic downturn.<sup>16</sup> Since interest rates influence the level of economic activity within an economy, it is also something a private equity firm should take into account. When interest rates are lower, there is less of a demand to save. As a result, people have more money that they are willing to spend, thus there are higher prices for assets due to increased demand. The initial rate of return (IRR) that a private equity firm accumulates when exiting a company is dependant on the interest rates on the debt the firm initially takes on. Low or declining interest rates mean that the timing is good for a private equity firm to buy. IPO activity also tends to increase when there are low interest rates.<sup>17</sup> This means that if a private equity firm is looking to exit, this is an ideal time. A rise in interest rates have the opposite effect. This circumstance hurts private equity firms who are looking to exit, but are beneficial for firms looking to buy. Private equity firms that buy when the interest rate is high also need to be cautious to make sure they can sustain the cash flow that is needed.

Private equity is also linked to increases in the investment level as well as the investment cash-flow sensitivity of the firms.<sup>18</sup> The cash-flow sensitivity of a firm is a concept that is used to

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<sup>14</sup> Moya, Elena. "Meet the Bankruptcy Barons Who Turn Bust Into Boom." *The Guardian*. (January 26th, 2009).

<sup>15</sup> Jacobius, Arleen. "Distressed debt investors await new round of defaults." *Pensions & Investments* 34, no. 5 (March 6, 2006): 3-41. *Business Source Complete*, EBSCOhost.

<sup>16</sup> Ibid.

<sup>17</sup> Agarwal, Kushar. "How Interest Rates Affect Private Equity." *Investopedia*.

<sup>18</sup> Dhankar, Raj. S., and Kunjana Malik. "A Dynamic Panel Data Analysis: The Effect of

measure imperfections in the capital market. A high investment cash-flow sensitivity is when the investment depends on the cash-flow of a firm, whereas low investment cash-flow sensitivity means that the investment level of the firm does not depend on the firm's cash-flow sensitivity. A study showed that there are correlations between private equity and an increase in the investment level and cash-flow sensitivity when analyzing firms in India.<sup>19</sup> A higher investment level and cash-flow sensitivity shows the greater reliance companies are having on private equity firms. The success of many of the companies analyzed are in the hands of private equity firms and the cash-flow that they bring. This is an increasing statistic that PE firms should be aware of, specifically when looking at acquisitions in India, but also all over the world. PE firms need to recognize companies that rely on cash-flow from their firm and how they need this sustained. If the cash-flow is not sustained, the company and the PE firm will be hurt as a result of the risk that is involved.

### **Visualization**

Private equity firms need to be good at identifying critical strategic levers that drive improved performance. They are regarded as having exceptional financial controls, while also constantly striving to improve their performance basics. Private equity firms utilize the experience that they have to create future opportunities to improve revenues and margins when turning another company around. It is evident that private equity firms are good at selling companies, however how do they find buyers willing to pay a good price? There is usually an exit strategy in place when the acquisition of a company is made. Private equity firms need to

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Private Equity on Investment and Financial Constraints of Indian Companies." *Journal Of Private Equity* 18, no. 4 (Fall 2015): 65-74. Business Source Complete, EBSCOhost.

<sup>19</sup> Dhankar, Raj. S., and Kunjana Malik. "A Dynamic Panel Data Analysis: The Effect of Private Equity on Investment and Financial Constraints of Indian Companies." *Journal Of Private Equity* 18, no. 4 (Fall 2015): 65-74. Business Source Complete, EBSCOhost.



have a vision and a plan to achieve that vision when buying a company. Their ability to attempt to predict a relatively accurate exit price is one of the largest factors in making a valuation of a target and certainly attributes to the success of a firm.

Having a vision in private equity does not only apply to the exit strategy but also the initial understanding of a company's potential. A great example of this is how Canada Pension Plan Investment Board (CPPIB) shared the same vision that Skype had for the potential of the company. CPPIB is a firm that has been known for making safe investments, some of which included: Waterworks, power grids, airports, and toll roads.<sup>20</sup> So, in 2009, when CPPIB invested \$300 million of their capital into a tech company it was surprising. However, Microsoft bought Skype in 2011 and in this case CPPIB was immensely rewarded for taking the riskier investment. The firm's take in the sale was at around \$1.1 billion before paying off some of the debt, and after paying off the debt CPPIB came away with just shy of \$1 billion. A private equity firm's ability to envision the future of companies they want to acquire will lead to more confident decision making and can result in attractive returns.

### **Crisis Management**

Although there has been a major increase in private equity investments, it should be noted that past performance does not reflect future returns. Just because private equity firms have had success in previously does not mean that this will continue. This leads me to my next point which is, a private equity firm should address crisis management within the private equity firm itself. There are unpredictable crises that may occur within a firm and in this case it is highly advised to respond quickly. If a firm has allegations of misconduct, fraud, or bribery, the firm's

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<sup>20</sup> Lago, Josep. "CPPIB scoops windfall as Microsoft buys Skype for \$8.5-billion." *The Globe And Mail*. (May 10th, 2011).

reputation is at stake, thus in order to minimize harm to the firm the situation should be dealt with as fast as possible.<sup>21</sup> While private equity firms want to create high returns, it is just as important to do thorough and accurate work in order to try and avoid potential crisis allegations. All the hard work that goes into analyzing, acquiring, and turning around a company may have negative results if a crisis occurs and is not dealt with correctly. This is why it is crucial that a private equity firm does not overlook this aspect.

### **Conclusion**

As discussed in this article, a private equity firm, despite the firm's investment preferences, can lessen their risk without negatively affecting the potential gains in their assets and capital by making the right considerations. This applies to both firms that are more risk seeking and firms that are also more risk averse. Being able to create meaningful relationships with people, whether that be with investors or companies, will increase the private equity firm's chance at acquiring good deals and the firm's potential at having long term success. Taking significant precautions and careful analysis of a company before acquisition will increase a firm's ability to make educated and beneficial decisions in regards to management and the acquisitions they will make. Ultimately, this will help a PE firm avoid potential harm that could present itself. The way a firm is able to envision the future of a company they are looking at acquiring is another attribute that will help propel a PE firm forward. If a private equity firm is able to keep all this in mind they will have an opportunity to make high returns in the risky world that we live in.

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<sup>21</sup> Shah, Shruti. "Top Six Risks for Private Equity Firms." *Forbes* (July 5th, 2017).

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