

## The new kings of capitalism

**In two decades, private-equity firms have moved from the outer fringe to the centre of the capitalist system. But, asks Matthew Bishop, can they keep it up?**

"IF YOU made 'Private Equity: the Movie', then Michael Douglas would have to play Schwarzman." The head of one multi-billion-dollar private-equity firm is talking about the head of another, the Blackstone Group's Steve Schwarzman. "I'm joking," he adds quickly, "Steve and I are good friends." Perhaps he realises that comparisons with the fictional Wall Street banker famously portrayed by Mr Douglas, Gordon "greed is good" Gekko, are not what his industry needs just now. In fact, Hollywood has already set its sights on the men who run this enormous, relatively unaccountable pool of capital. This year, the Carlyle Group, a huge private-equity firm, has been vilified in Michael Moore's film "Fahrenheit 9/11", as well as being named as the inspiration for a fictional private-equity firm that tries to install its brainwashed candidate as American president in the remake of "The Manchurian Candidate".

Yet 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 Schwarzman and his peers in the private-equity industry who control the really smart money and wield the lasting influence. This survey will explain what they do, what challenges they face and what effect they have on the world of business at large.

In 1985, when Blackstone was founded by Mr Schwarzman and Pete Peterson, a former commerce secretary under Richard Nixon, private equity was a cottage industry that few people had heard of. There had always been family-owned private firms, but family owners did not usually aim to sell off the business; they passed it on to the next generation.

Until the late 1970s, the main activity in private equity--buying shares in private companies in the hope of selling them at a higher price later--had been carried out mostly by the investment arms of a few wealthy families, such as the Rockefellers and Whitneys in America, and had generally been confined to venture-capital investment in small, fast-growing businesses. America's venture capitalists have become the envy of the world for developing firms such as Intel and Google from nothing more than a bright idea into big, successful companies. But these days less than one-fifth of the money the industry raises goes on providing venture capital for young firms. Much the larger part of private-equity money is spent on buy-outs of established companies.

The first of today's big private-equity firms, Warburg Pincus, was formed only in the late 1960s, and had to raise money from investors one deal at a time. By the late 1980s private equity had grown big enough to be noticed by the general public, but it made hostile headlines with a wave of debt-financed "leveraged buy-outs" (LBOs) of big, well-known firms. The industry was cast in the role of irresponsible "corporate raider" attacking from the wilder fringes of capitalism. A bestselling book by Bryan Burrough and John Helyar about the \$25 billion battle in 1988 for RJR Nabisco branded two private-equity firms, Forstmann Little and Kohlberg Kravis Roberts (KKR), as "Barbarians at the Gate".

Today, the private-equity industry has moved from the fringe to the centre of the capitalist action. In the process, the leaders of private equity have earned themselves both wealth and respect--if not always respectability. The fabulously rich Mr Schwarzman pops up in the society gossip pages for such things as paying a record \$37m for a Manhattan apartment and for demolishing his Florida mansion, allegedly without permission. He is often tipped as treasury secretary in a Republican administration.

## A magnet for the best

In the 1980s private equity was a place for mavericks and outsiders; these days it attracts the most talented members of the business, political and cultural establishment, including many of the world's top managers. Jack Welch, the legendary former boss of GE, is now at Clayton, Dubilier & Rice. Lou Gerstner, who revived IBM, is chairman of Carlyle. Even Bono, the saintly lead singer of rock band U2, is now in the business.

Moreover, as Hollywood has noticed, private-equity firms have become the employer of choice for politicians and government officials returning to the private sector. Blackstone has hired Paul O'Neill, until recently America's treasury secretary. Carlyle has provided lucrative work for numerous luminaries, including George Bush senior, Fidel Ramos, a former president of the Philippines, John Major, a former British prime minister, and Arthur Levitt, a former chairman of America's main financial-markets regulator, the Securities and Exchange Commission (SEC).

Private equity's transformation into a mainstream industry has been greatly helped by a fundamental change in the sort of deals it does. In the late 1980s, funds often borrowed to the hilt to pay for buy-outs, many of which were seen as hostile by the management of the intended targets. Nowadays the buy-out firms' deals involve much less debt. When KKR bought America's Safeway supermarket chain in 1986, it borrowed 97% of the \$4.8 billion the deal cost it; now a private-equity firm would typically have to stump up around one-third of the purchase price.

Hostile deals are now extremely rare. Even Britain's Philip Green, one of a small band of powerful individual private-equity financiers, declined to go hostile this year in his bid to buy Marks & Spencer, a British retailer. Indeed, big companies that would once have turned up their noses at an approach from a private-equity firm are now pleased to do business with them. Royal Dutch/Shell, a troubled oil giant, has been negotiating the sale of its liquefied-natural-gas business for \$2.45 billion to KKR and Goldman Sachs Capital. Some companies even team up with private-equity firms, as Sony recently did with Texas Pacific Group (TPG) and Providence Equity Partners to buy MGM, a film studio.

Having largely shed the image of corporate wreckers, private-equity firms can now plausibly describe themselves as providing a safe haven in which firms can pursue long-term growth, sheltered from the short-term storms of the public stockmarkets. This role is all the more important because both venture capitalists and buy-out firms work increasingly with firms undergoing big changes. Well-known firms that have recently been "nurtured" by private equity include Burger King, Polaroid, Universal Studios Florida, Houghton Mifflin, Bhs, Ducati Motor and the Savoy Group.

Private-equity firms can also reasonably claim to offer a solution (though an expensive one) to the corporate-governance problems that have blighted so many public companies. "If you examine all the major corporate scandals of the past 25 years, none of them occurred where a private-equity firm was involved," noted Henry Kravis, one of the founders of KKR, in a recent speech. Private-equity firms, he said, are "vigilant in our role as owners, and we protect shareholder value." On the other hand, if there were any impropriety in a private company, the public might not get to hear about it.

Clearly, private equity is now a big business. In Britain, for instance, one-fifth of the workforce outside the public sector is employed by firms that are, or have been, invested in by a private-equity firm, according to the British Venture Capital Association. Worldwide, there are more than 2,700 private-equity firms, reckons Goldman Sachs (maybe many more, because in this private world small firms can easily drop below the radar screen). As pension funds, endowments and rich individuals have become increasingly keen investors, the amount of private equity has

soared. In 2000 alone, the peak year so far, investors committed about \$160 billion to private-equity firms (much of it to venture capital), up from only \$10 billion in 1991.

At the same time, there has been a dramatic growth in the size of private-equity funds, and in the size of the top firms that manage them. Most private-equity firms raise funds as limited partnerships. The firm is the general partner that manages the fund and gets paid an annual fee (a percentage of the money in, or promised to, a fund) and later a large slice of any profits; outside investors (who often lock up their money for up to ten years) become limited partners who share only in the profits.

In 1980, the world's biggest fund (KKR's) was \$135m. Today there are scores of funds with over \$1 billion each. J.P. Morgan's latest one is currently the biggest, at \$6.5 billion, ahead of Blackstone's (see chart 2, next page); Permira has Europe's largest, at around \$6 billion at today's exchange rate. A \$10 billion fund can be only a matter of time, if only for the fabulous annual fees.

Blackstone, which started life as a two-man band working from a single room, has become, in its own words, "a major player in the world of finance". It employs over 500 people in plush offices in New York's Park Avenue, Boston, Atlanta, London, Paris and Hamburg. The 35-40 firms in which it has a private-equity stake together have over 300,000 employees and annual revenues of over \$50 billion--which, were they lumped together as a single conglomerate, would make Blackstone a top-20 Fortune 500 company. Other big private-equity firms can point to similar numbers. TPG's portfolio of firms has 255,000 staff and collective annual revenues of \$41 billion; Carlyle's has 150,000 workers and revenues of \$31 billion.

Yet the private-equity industry must now grapple with tough new challenges. These fall into three broad and overlapping categories: generating good financial performance; coming up with winning strategies in a rapidly maturing industry; and becoming more accountable to the public, and thus less private.

There are few industries in which the gap between the best and the rest is as large as in private equity. The top firms have delivered far better returns to investors than the stockmarkets have done, but the average private-equity fund has actually produced worse results (after fees) than public equities. That includes buy-out funds as well as the venture-capital funds that destroyed so much capital during the tech bubble a few years ago.

In future, the industry may find it hard to match even this not-too-glittering past performance. Private equity may become a victim of its own success. Techniques such as seeking to maximise cashflow, using debt astutely and paying managers with shares, which were novel when private-equity firms first introduced them in the 1970s, have become standard business practice. As Mr Kravis put it in his recent speech, "Everything we have accomplished in driving corporate excellence makes it harder for us to achieve the returns that our investors expect from us."

A crucial factor will be whether private-equity firms can genuinely improve the companies they buy. Another will be how easily they can dispose of their investments. Without an "exit", there can be no profits. Two main exit routes--selling a firm to a big corporate buyer or floating it on a public stockmarket through an initial public offering (IPO) of its shares--have recently been much harder to pursue than in the past; and increasingly popular alternatives, such as selling to another private-equity firm, are becoming controversial.

Much will depend on how investors respond. On one hand, many have been disappointed at private-equity firms' average past performance; on the other, at a time when bonds and public equities are delivering historically low yields, the high returns generated by the best private-equity

firms look increasingly enticing. European institutional investors, which have traditionally invested little in private equity, are beginning to show more interest. If investors pump more capital into an industry that arguably already has too much of it--especially now that hedge funds, flush with cash, are also piling into private equity--there is every chance of creating another bubble, hot on the heels of the one in venture capital.

Not only are good opportunities becoming harder to find, but being a maturing industry throws up other tricky issues. Many of the leading private-equity firms are still run by their founders, who are now getting to an age where they have to consider bowing out. As is often the way with charismatic founders, some may linger too long. And even when they go, the handover may prove highly disruptive as some of those passed over for the top job leave the firm. Nor can there be any guarantee that the next generation, clutching their MBAs, will inherit the deal-making magic of the founders.

### **Piggy in the middle**

Will tougher competition and increasingly demanding investors cause the industry to consolidate? Sir Ronald Cohen of Apax Partners thinks that over the next decade the private-equity industry will polarise. At one end, a few big global industry leaders will emerge--"maybe three or four dominant brands with high returns"; at the other, small specialist firms will thrive. In the middle, however, many firms will find it hard to compete. His prediction is plausible, and the losers may include some famous names. Forstmann Little has already said that it will close in 2006. It made some awful telecoms investments during the bubble and has failed to resolve its succession problem.

Some of the biggest private-equity firms are already staking out different territories. KKR and Apax say they will continue to concentrate on private equity. But Blackstone and Carlyle have been adding other financial products to their portfolio. Blackstone, for example, which has long run property funds, is toying with starting a hedge fund as well as beefing up its existing business providing advice on mergers and acquisitions. Diversification, these firms hope, will help them to exploit their expertise and brands--and perhaps to generate a more stable stream of profits that may allow them to float on the stockmarket one day. But critics ask whether there is any real synergy between the different sorts of "alternative assets" they offer.

Will private-equity firms be able to maintain their privacy when transparency is increasingly expected in every walk of life? The answer may depend on politics as much as on economics. Most private-equity firms fiercely oppose greater transparency, arguing that it will rob them of their magic. Many tacitly accept that their performance will soon become subject to much more intense scrutiny, and that they will have to adopt sensible industry standards for valuing their portfolios. But they are desperate to avoid having to disclose details about the performance of individual firms in their portfolios. Such disclosure, they say, would quickly subject those companies to the same sort of damaging short-term pressures that they would face in the public equity markets.

But change is on its way, if only because of the growing amount of money being invested in private equity through public pension funds. In America, freedom of information acts have prompted some public pension funds to provide details of the performance of their investments in different private-equity firms, to the horror of most of the firms concerned. Yet, as Thomas Lee, founder of the eponymous private-equity firm, concedes, "We are using so much public money that we have an obligation if not to be transparent then to be a little less invisible than in the past." How much less invisible will be explored later in this survey. But first, a quick look at past form.

## Pick carefully

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### Some private-equity firms are much more successful than others

It's done  
with mirrors

FROM its creation in 1976 to the end of 2003, KKR invested \$18.4 billion. The firm calculates that these investments have increased in value to \$49.7 billion, of which \$39.3 billion has already been banked. Amid much fanfare, in the past 18 months it has returned \$9 billion in cash to investors, beating even Carlyle's equally trumpeted cash return of \$6.6 billion.

This sort of performance makes it easy to see why investors are so keen on private equity. Yet it has been the exception, not the norm--which has mostly been to lag behind even the public equity markets. And although KKR continues to proclaim that "private equity will outperform public equity and other investments over the long term," even the best firms may struggle to match their past success. KKR itself is now viewed in the industry as a shadow of its old self, concentrating increasingly on lower-risk, lower-return deals.

From 1980 to 2001, the average private-equity buy-out fund generated slightly lower returns to investors (after subtracting fees to general partners) than they would have obtained by investing in the S&P 500, according to a recent study by Steve Kaplan of the University of Chicago and Antoinette Schoar of the Massachusetts Institute of Technology. The median venture-capital fund also fell just short of matching the S&P, although an average of venture-capital firms weighted by how much capital each had invested beat it by a short head. However, gross returns (ie, before fees) on both buy-outs and venture capital did beat the S&P during that period--probably by a sizeable margin, fees being what they are (see box, next page), concludes the study.

Mr Kaplan and Ms Schoar also found huge differences between individual funds. The top quartile of private-equity funds produced an annual rate of return of 23%, well ahead of the S&P; the bottom quartile earned investors only 4% (see chart 3). Other experts have come to similar conclusions. Greenwich Associates, a pension-fund adviser, says that typically "only the top 25 private-equity funds generate better returns than the S&P."

An even gloomier picture is painted by one of the most successful investors in private-equity funds, David Swensen, who has been chief investment officer of the now massive Yale University endowment since 1985. In a classic book, "Pioneering Portfolio Management", published in 2000, Mr Swensen is scathing about the performance of much private equity--particularly as the past two decades may have been uniquely favourable for private equity, with falling interest rates making borrowing cheaper, a relatively small number of private-equity firms competing, lots of badly run companies to improve and a sharp rise in the multiple of share price to profits that investors in public stockmarkets would pay.

And even the performance of the few funds that did beat the S&P needs careful examination. Being much less liquid than public equities, private-equity investments should offer a premium over the S&P to justify the extra risk. This point is lost on some investors, who think that private equity is less risky because its reported value is much less volatile than public equities. But the main reason why private equity is less volatile is that it is only rarely revalued--and then usually in an unsatisfactory way. To say that private equity is less volatile and thus less risky is a bit like saying that the weather does

not change much when you stay inside and rarely look out of the window.

### **It's done with mirrors**

But there is a further common flaw in making comparisons with the S&P. Mr Swensen looked at 542 buy-out deals that were started and concluded during 1987-98. At first sight their performance looked impressive, with annual returns of 48%, compared with 17% if the money spent on each deal had been invested in the S&P for the same period of time. But most of these gains, Mr Swensen points out, came from heavy borrowing by buy-out firms seeking to multiply their private-equity bet.

If the same amount of debt had been used to multiply the investments in the S&P, the leveraged portfolio of public equities would have generated an 86% return, beating the buy-outs by nearly 40 percentage points a year--or nearly 50 points after fees. Yale took part in only 118 of the 542 deals, generating gross returns of 63% a year, comfortably beating (even after fees) comparably leveraged S&P investment returns of 41%. Not for nothing is Mr Swensen regarded as a private-equity genius.

Why did the average fund perform so poorly? Size does not seem to have been decisive, according to the study by Mr Kaplan and Ms Schoar. In venture capital, the larger funds of the 1990s tended to perform better than their smaller counterparts in the 1980s. But the opposite was true for buy-out funds, which struggled in the early 1990s even though they had got bigger. One possible explanation is that venture capitalists had much better investment opportunities available to them in the 1990s, as the technology revolution gathered speed, whereas buy-out funds were badly hit by the collapse of the junk-bond market in the late 1980s and the recession of the early 1990s.

Location may also have played a part. Various studies have shown that, during the 1990s at least, European-based private-equity funds (mostly concentrating on buy-outs) delivered better returns than their American counterparts. Possible causes range from less competition to better deals available because of corporate Europe's relative inefficiency.

Not only is there a large gap between the best private-equity funds and the rest, but their respective performances have also been remarkably consistent. Mr Kaplan and Ms Schoar found that the winners in private equity tend to keep on winning, and the bad firms stay bad--if they remain in business. This is in sharp contrast to mutual funds and, to a lesser extent, hedge funds, where star performers tend quickly to return to the average. If a private-equity firm's first fund performs well, its second and third will probably do likewise--even more so in venture capital than in buy-outs.

Why? Some private-equity firms may have better access to "proprietary" deals in which they are the only bidders, so their costs will be lower than if they had to compete for deals. But with the increased use of auctions in sales to private-equity firms, this has become a much less likely explanation for superior performance. More plausibly, venture capitalists with a reputation for successfully nurturing start-ups may be offered better opportunities. Or perhaps there are simply just a few people in private equity who are very much better at it than their rivals. There is, after all, only one Henry Kravis.

Mr Swensen argues that the deals Yale invested in produced better results than the rest of those he studied because his institution took a different approach to private equity. It invested in funds whose deals involved much less debt and much more attention to

improving the operating performance of the firms concerned.

Another explanation for the poor performance of many private-equity firms may be the inadequacies of their main investors. The vast majority of capital going into private-equity funds comes from institutional investors of various kinds. Some sorts of institution seem to do a consistently better job than others at picking private-equity winners, according to "Smart Institutions, Foolish Choices?", a fascinating new study by Ms Schoar with Josh Lerner and Wan Wong, both of Harvard Business School.

Among funds raised in the ten years to 2001, those that attracted investment by the endowments of universities and not-for-profit foundations did 14 percentage points a year better than the average fund. Funds picked by investment advisers (including funds-of-funds, which invest as limited partners in a portfolio of private-equity funds) and banks performed well below average (see chart 4, previous page). The more endowments invest in a fund, the better it is likely to perform; the more banks invest, the worse it is likely to do.

According to the study, these striking differences cannot be explained away by the fact that endowments have been involved in private equity for longer, and thus tend to get better access to new funds being raised by the leading private-equity firms. Endowments have been just as good at picking out new private-equity firms that subsequently go on to do well.

The most likely explanation is that the leading endowments have sophisticated, relatively well-paid staff who monitor performance carefully. Harvard's endowment reputedly paid two of its analysts \$35m apiece last year. Advisers, banks and others who sell funds-of-funds may have financial incentives to maximise sales, but may not care how the fund itself performs.

Banks' in-house private-equity funds often perform poorly because of conflicts of interest: they may be made to invest in a company because the bank hopes to win other banking business from it later. They also pay their staff less generously than others. Indeed, banks are now quitting the private-equity industry, both because of poor past performance and because of tougher rules on how much capital they must set aside to cover the risk involved.

But even those private-equity funds that have done well in the past may find it harder to do so in the future, as the next article will explain.

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## Highly leveraged

### A gravity-defying pay structure

NICE work if you can get it. The general partners who manage private-equity funds are lavishly paid. They receive an annual management fee, usually 1.5-2.5% of the fund's assets, and also get a share of any profits made from the fund's investments after the initial capital has been repaid to limited partners, a payment known as the "carried interest". This is usually 20% of net profit, although some firms, particularly venture

capitalists, set their "carry" as high as 30%.

As if that were not enough, some private-equity firms levy charges for things such as monitoring the firms in a fund's portfolio, ending the monitoring arrangement when the firm is sold, and even for providing some of the investment-banking services involved in buying or selling firms in the portfolio.

In the early private-equity funds, in America at least, the carry was taken on each deal that made a profit, not on the aggregate performance of a fund. So, as long as some individual deals were profitable, general partners could collect a carry even if the fund lost money overall. From the late 1980s, under pressure from limited partners, funds started to calculate the carry on aggregate profits--though some firms, including KKR, were slow to embrace this new norm.

In practice, American private-equity firms have often taken their carry each time a deal is profitably concluded--with the proviso that if the fund turns out not to be profitable overall, limited partners can claw back these payments. In Europe, general partners do not usually receive any carry until a fund has repaid all of the capital invested by its limited partners. Lately, private-equity general partners have become jealous of hedge-fund managers, who also have a "2-and-20" reward structure, but typically get their carry at the end of every year.

Intriguingly, private-equity firms have rarely tried to compete for capital by lowering their take, perhaps because investors might interpret it as showing a lack of confidence. Warburg Pincus cut its carried interest in the early 1990s, but no one followed suit. Barry Wolf, a private-equity lawyer at Weil, Gotshal & Manges, says that when the tech bubble burst, many people expected investors to put pressure on the payment terms of new funds. But instead of attacking terms, they took an all-or-nothing approach to investing in new funds: those raised by firms with a generally good record got oversubscribed, bad performers got nothing.

If it gets harder to make profits by investing, private-equity firms will probably try to earn bigger management fees by raising ever larger funds at more frequent intervals. Jon Moulton of Alchemy, a British private-equity firm, is puzzled: "A lot of people in the industry already make several million a year without having to perform. I can't understand why investors haven't put more pressure on fees."

## Small expectations

### Things are likely to get harder rather than easier

SOME of the ageing superstars of private equity dismiss current predictions that competition will drive down returns. They have heard it all before. "There are still lots of great deals out there," says Thomas Lee. "The past couple of years have been a golden age for private equity."

There is some truth in this. The years immediately following the tech bubble, the economic slowdown, the terrorist attacks of September 11th 2001 and the collapse of Enron offered plenty of opportunities for private-equity firms with the courage to invest. Soon after September 11th, several private-equity firms set up a clutch of catastrophe-risk insurance companies based in Bermuda, which have now been sold at a huge profit. "We should have bought everything in sight after 9/11," says Mr Lee. "It needed minimum brains, maximum

guts to do those deals." At the same time, big companies such as GE and Tyco, which had hitherto been competing hard with private-equity firms for potential acquisitions, backed away from the market or even became eager sellers of non-core businesses.

Yet this period may prove to have been only a brief reprise of the high returns of private equity's early years, not a sign that the industry has put its troubles behind it. Nowadays even the best private-equity firms are mostly aiming to achieve annual returns of only 15-20% on their capital, down from 20-25% in the 1990s and over 30% in the 1980s--though in the buy-out business they still hope at least to double their money on every investment. Private-equity firms now talk much less about the absolute returns they expect to make. Instead, they promise better returns than those available in public equities--which, given the stockmarkets' miserable performance lately, may not be saying much.

Some make bigger promises than others. "We expect to do 2,000 basis points better than the market in all conditions," says the boss of one big firm. Carlyle is aiming for 1,000-1,500 basis points above the market. Most firms, however, feel that investors would settle for 600 points better than the stockmarket as sufficient reward for the illiquidity and, perhaps, the greater risk of private equity.

For a variety of reasons, returns may fall short of even these modest targets. There is already lots of capital chasing deals: some \$100 billion has been raised but not yet invested, hedge funds are piling in and a new cycle of fund-raising is getting under way. So far, funds with a good reputation are finding a keen response from investors, especially in Europe: Allianz, Germany's biggest investor in private equity, has said that it is planning to invest much more. Bain Capital recently raised a \$4 billion fund in only a few weeks instead of the usual few months.

In the past, private-equity firms were able to do a fair number of "proprietary deals" in which they had no competition. Now, even though the number of deals is increasing, all but the smallest firms are sold through a competitive auction organised by the seller's investment bank. Competition can be intense, with deals attracting from half a dozen to many dozens of bidders, and auctions almost always result in higher prices.

## Profitable ploys

Private equity thrives on finding inefficiencies to exploit. Fees aside, there are several well-established ways for its firms to make money. The four main ones are:

- Improve the profitability of the companies they buy, so that they can sell them for more than they paid for them.
- Buy low, sell high. Some companies fall temporarily out of favour with investors, so their shares trade at a low multiple of their profits or cashflow. Private-equity firms can buy them and wait until the market is more bullish and multiples are higher (though they may find that there was a good reason for the low valuation). Valuation multiples also tend to rise as firms get bigger, so simply holding a business and letting it grow may boost its multiple from, say, six to eight over a few years.
- Break it up. Some businesses trade at a value that is less than the sum of their parts. They can be broken up and sold in pieces for more than the purchase price. Some part of the business may distract management from a company's core operation or drain scarce resources from it. Selling it off not only raises money but may also result in a more focused and therefore more valuable core business.
- Use leverage. Borrowing can multiply any gains made by the first three methods. A private-equity firm buys a company for, say, \$100m. It pays for it with \$10m of its own equity capital and borrows the remaining \$90m. It later sells it for \$110m. After repaying the debt, it has

doubled its money even though the value of the firm has increased by only 10%. The risk, however, is that if things go badly and the private-equity firm is unable to service and repay the loan, its capital may be wiped out in the bankruptcy courts.

In practice, many private-equity firms deploy all these methods. But broadly speaking, in the 1980s, when debt was plentiful and target companies were not highly leveraged in the first place, private-equity firms concentrated more on finding undervalued assets, selling off the pieces and greatly boosting their yield with leverage. In the 1990s, the increasingly bullish stockmarket allowed such firms to benefit handsomely from rising price-to-profit multiples. Today, the firms may have to earn most of their money by improving the companies they own.

### **Standard practice**

One problem is the commoditisation of many of the activities that gave private-equity firms a competitive advantage in their early days. When people such as Henry Kravis started doing deals, the effective use of leverage and the importance of cashflow was a mystery understood by only a few; now it is taught in every business school. Private-equity firms have become a huge source of business for all sorts of professionals, from consultancies, executive search firms and back-office companies (such as BISYS, the industry leader) to law firms and investment banks (Blackstone alone paid Wall Street firms around \$700m in fees in 2003). As a result, the techniques of doing deals have become standardised. That has lowered risk but increased competition by making it easier for less experienced firms to bid.

Ultimately, private equity is all about making a successful exit. The traditional solutions are either selling to a trade buyer (typically a company in, or trying to get into, the same industry as the firm being sold) or turning the firm into a public company via an IPO. In the past two or three years, both of these exits have become narrower than they were during most of the previous decade.

Many of the IPOs that took place during the tech boom subsequently melted down, so now investors have little interest in buying shares in start-ups without a record of profitability. Google's IPO earlier this year may have attracted a lot of attention, but it has not made investors much keener on other tech IPOs. Most private-equity firms believe that it will be years before the IPO market returns to the levels of 2000--if indeed it ever does.

At the same time, corporate buyers remain reluctant to make all but the most obviously sensible acquisitions. Under pressure from shareholders, their boards have come to regard the large number of ill-advised takeovers and mergers during the bubble years as evidence of corporate-governance failure during that period.

Helpfully, two new exit routes have opened up in the past few years. The first is recapitalisation. Recently a few second-tier banks have become much keener on lending to finance private-equity deals. They are now willing to value firms at much higher multiples of profits than even 12 months ago, and to lend against those values. Many private-equity firms have taken advantage of this to "recap": increasing the amounts borrowed by the firms in their portfolios, then using the extra money raised to make dividend payments that the fund distributes to its limited partners.

Will this exit stay open for long? There are only so many times a firm can be revalued and recapitalised. Recaps are anyway only a partial solution, for the firm still remains in the hands of its private-equity owner. And it may not be prudent for banks to lend at such high

multiples. It would not be the first time that their pursuit of loan origination fees has led to laxity in their credit judgments. When they or their regulators notice how lax they have become, this particular door may slam shut just as suddenly as the IPO one did.

The other currently fashionable exit strategy is for one private-equity firm to sell to another, a technique known as a "secondary buy-out". (This should not be confused with the "secondary market" in which one investor can sell its limited partnership in a fund to another investor. This market is also growing fast.) Over the past two years, secondary buy-outs have accounted for a rapidly rising proportion of sales by private-equity firms.

Some observers view these "buy-outs of buy-outs" as evidence of the growing maturity and specialisation of the industry. Others wonder what they will get out of this game of "pass the parcel". "The results of these deals may prove most disappointing," says Michael Stoddart, a British private-equity veteran at Fleming Family and Partners. Anything the buyer could do to improve its acquisition may already have been done by the seller. And what is the benefit to the limited partner who has invested in both the buying and the selling private-equity firm and thus ends up still owning the firm that has been sold, minus the fees for the general partner of the selling fund? Some limited partners even worry that such deals may involve some mutual back-scratching, in which one firm buys from another on the understanding that the seller will later return the favour.

There is another exit that private-equity firms are increasingly having to think about: that of their top brass. As the industry has matured, so has its pioneering generation of leaders. The duo in charge of KKR, Mr Kravis and George Roberts, are around 60, as is Mr Lee. Teddy Forstmann of Forstmann Little is 64. Increasingly, limited partners--who, after all, must lock up their cash with private-equity firms for many years--want to know who will succeed the current bosses, and when. So, too, do the candidates who might take over. Lionel Pincus, now 73, lingered so long at Warburg Pincus that when he finally gave up operational responsibility, a whole generation of heirs apparent had left.

Some firms have embraced succession planning more willingly than others. The founder of Apax, Sir Ronald Cohen, set a mandatory retirement age of 60 long before he himself reached it. Apax now has a new chief executive, Martin Halusa, 49. At Permira, power has passed smoothly to a new generation. Mr Lee has delegated day-to-day responsibility for his firm to others. TPG's David Bonderman now describes himself as more a chairman than a chief executive. Blackstone has recruited an emerging next leader, Tony James.

## The long goodbye

By contrast, Forstmann Little, which has failed to develop any potential successors to Mr Forstmann (and has also put in an abysmal performance recently), recently announced that it will go out of business when Mr Forstmann retires in 2006. Mr Kravis, for his part, plans to stay at the helm for many more years. He says that KKR has a deep bench of talent, so there is no doubt that the firm will thrive after him.

What should a founder be paid for giving up his partnership? Founders tend to have a large stake in their firms, so buying it could be a serious drain on the finances of the remaining partners. Apax's partners had a meeting to agree on what they regarded as a reasonable price. Other strategies for cashing in the founders' stakes, much discussed in private-equity circles, include selling the firm to a bigger financial institution, or floating it.

The trouble with replacing a set of highly charismatic founder-leaders is that their successors may seem less inspiring. As one limited partner put it, they will certainly "all be very bright

and numerate, with MBAs, very analytical. But I worry they may be more like bank officers than deal-making geniuses."

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## Beating the mid-life crisis

### Contents

### What private-equity firms are doing to win in a mature market

#### The rise of the specialist

"PRIVATE-equity firms are only now starting to do aggressive branding," says David Rubenstein, boss of the Carlyle Group, a top private-equity company that has probably devoted more thought to its brand strategy than anyone else in the industry. This task has been complicated by Carlyle's recent elevation to public enemy number one, on film by Michael Moore and, more thoughtfully, in Dan Briody's book, "The Iron Triangle".

Carlyle's critics note that many former politicians have taken the company's shilling, and that some members of the bin Laden family and other Saudis not only invested in the firm but were attending its annual investors' meeting on September 10th-11th 2001. This, they aver, shows that Carlyle is at the heart of a worrying global military-political-industrial complex.

The company fiercely rejects such charges. It says that hiring politicians was not meant to secure deals; it was a marketing initiative intended to "help people get to know us". This approach has been widely imitated, says Mr Rubenstein: "Every private-equity firm now has its former senior government official hanging around, but it got identified with us." He says that, contrary to the firm's (un)popular image, "we are as ethical as any business in the world, and are proud that in over 17 years no government agency has ever fined us for anything." The bad press, he says, seems to have had no effect on private-equity investors, a smallish group who hold the firm in high regard. "We are raising more money than ever, recruiting more people than ever, doing more deals."

For what it's worth, Carlyle's rivals in the private-equity business also dismiss the conspiracy theories and, in a back-handed way, pay tribute to the firm's marketing prowess. Wooing the people in public-pension funds who invest in private equity may well be good policy. They tend not to be high-flyers, and may be influenced by rubbing shoulders with the great and good in a luxurious venue.

"Carlyle is the McDonald's of the industry--big, everywhere, schlocky," says one well-known deal-maker. Carlyle, he notes, is always on the road drumming up money to fill the constant stream of new fund "franchises" it opens. The company currently manages 22 funds of various sorts; the industry norm is to start one new fund every few years, typically involving a laborious fund-raising process that often lasts the best part of a year. "Carlyle is about as in charge of the world as McDonald's is," concludes the rival deal-maker.

Just like Carlyle, other leading private-equity firms now hope that establishing a strong brand will give them an edge. As private equity matures, they think, it will become like many other

industries, with a few leaders that can use their strong brands to charge higher prices, launch new products more easily, recruit top talent and attract the best business partners. Impressive past performance is likely to be a prerequisite for becoming a strong brand. But in an industry once dominated by lookalike generalists, the top firms are now pursuing very different strategies.

The main variables are the size of their funds and the degree of specialisation. Some have established a niche in particular kinds of deals or industries or geographical regions; others cover the whole range of private equity, or are even moving beyond private equity into other assets such as hedge funds. The market seems well aware of these distinctions. Increasingly, limited partners "divide funds into particular categories, sectors, types of deals, then go to the best of breed in each group," says David Thomas of Citigroup Venture Capital (a global technology-oriented buy-out firm, despite its name).

One crucial strategic choice is the size of deal to be pursued. It is fashionable to argue that competition is fiercest--and thus returns likely to be lowest--in the biggest deals, of \$1 billion and up. These are in relatively short supply. All of them involve auctions among the largest, most competitive funds. Mid-sized deals are often seen as a better bet--more common and more diverse, and thus providing more opportunities for specialist private-equity firms.

Yet mid-sized deals are increasingly allocated by auction, too. The poorest performers in private equity are concentrated in this part of the market. "A lot of firms in the mid-market know they are never going to be able to raise another fund, so they're throwing their money around," says the boss of one of the firms that concentrate on bigger deals. Mid-sized auctions tend to involve many more bidders, perhaps dozens. Bigger deals are often fought out by no more than three funds or consortia.

Consortium deals--known as "club deals"--have become increasingly common. A recent example was the joint purchase in July by KKR, Blackstone, TPG and Hellman & Friedman of Texas Genco, an energy firm, for \$3.65 billion. Some clubs include non-financial firms: TPG and Providence Equity Partners recently teamed up with Sony to buy MGM.

But club deals are controversial. On the plus side, a consortium can do bigger deals. Most funds have an upper limit on how much of their capital they can put into any one deal, typically around 10%. So even a \$5 billion fund, assuming it could borrow, say, three times the equity it puts in, might not be able to bid more than \$2 billion for any target firm on its own.

On the minus side, some sellers suspect big private-equity firms of forming (loose) cartels to make bidding less competitive. There is also the practical question of which member of the club will be in control of the company after it has been bought. Jack Welch, the former boss of GE, who now works for Clayton, Dubilier & Rice (CDR, see box), worries about what happens when the purchasers disagree about what needs to be done to improve the company, or when to sell it. But that risk does not trouble Mr Lee, whose firm is involved in lots of club deals. "All the top people in the big private-equity firms have known each other for years, and it is unlikely we are going to disagree fundamentally," he says. "Put the chance of a difference of opinion versus the opportunity to make lots of money, I'm prepared to take the chance."

Many of the most upbeat people in private equity today concentrate on small deals, not least because in this area there is little competition from the big funds. The funds pursuing small deals tend themselves to be small. "There is a stark contrast between small private-equity funds--maybe \$10m-50m, truly lean, often largely funded by the general partners, who have often been successful managers--and big firms that are really asset managers whose main expertise is fund-raising," says Roy Bingham of Health Business Partners, an investment banking firm specialising in small health-care-related deals.

Sentinel Capital, based in New York, goes for firms in the \$25m-125m range. There are lots of them, the scope for remedying inefficiencies is much greater than in medium-sized and large firms, and competition for deals is less intense--though that may change as the mid-market funds become more desperate for promising opportunities. Indeed, says David Lobel of Sentinel, mid-market firms are already keen buyers of companies that Sentinel has acquired and knocked into shape.

The leading private-equity firms have long claimed to add value to the companies they have bought. As the industry matures, they say, operational improvements will become the main source of profits, so they are upgrading their methods. CDR hired "Neutron Jack" to add rigour to the oversight of firms in its portfolio. KKR now draws up a detailed "100-Day Plan" ("not three pages, a line-by-line blueprint") for a firm immediately after its acquisition, in which its in-house consulting firm, Capstone Consulting, plays a crucial part.

### The rise of the specialist

"From now on, specialists will outperform generalists," says Glenn Hutchins of Silver Lake Partners, an American private-equity firm specialising in large, mature technology companies, a sector in which "you really have to understand the companies you invest in". Increasingly, all but the biggest firms are claiming to be specialists in particular sorts of deal.

And even some big firms are claiming to specialise in several things: for example, Apax says it has built expertise in six carefully selected industries. Electra Partners, a big British private-equity firm, says it specialises in finding firms with low growth and complex challenges that it thinks it can clean up and put on a faster growth track. Elevation Partners was launched in June by Roger McNamee, formerly of Silver Lake, and Bono, a rock star, to seek out deals in the media and entertainment industry. But specialisation itself is no guarantee of success: a private meeting with Bono persuaded investors to stump up \$1 billion, but can his fund do better than experienced and equally specialised rivals?

Some firms are trying to differentiate themselves by aiming for a wider geographical spread. For most American private-equity firms, "going global" is shorthand for beefing up their continental European operations. Several have now established a foothold in Europe, having tried but failed a decade ago. This time round they have realised that to succeed in Europe, with its many languages, cultures and legal systems, they need a strong local presence, mostly of local staff. Conversely, European private-equity firms are not seriously trying to crack the American market.

Europe has seen far more buy-out deals than other parts of the world in recent years, a trend that is widely expected to continue. "In Europe, unlike America, there will be opportunities to exploit inefficiencies for years," argues Graeme Johnson, European head of Deutsche Bank's private-equity-funds group. One reason, says Damon Buffini of Permira, is that whereas America has already unbundled most of its badly run conglomerates, Europe is only now starting to do so. But even in America, there are still a few opportunities to be found. Wilbur Ross, of WL Ross, for instance, made a remarkable--and remarkably lucrative--job of rationalising America's steel industry and shepherding it through the bankruptcy courts in 2002-03.

Asia has mixed appeal for private-equity firms. Most think that it has huge potential but are uncertain about their ability to take advantage of it. Many are now looking hard at Japan, following the success of Ripplewood and Christopher Flowers in buying Shinsei Bank out of bankruptcy, cleaning it up and floating it. Gillian Tett's gripping book about the deal, "Saving the Sun. How Wall Street Mavericks Shook Up Japan's Financial World and Made Billions", makes it clear that foreign private-equity firms with brains, patience and connections can make a fortune

in Japan.

Private equity is growing in India too. Gaurav Dalmia of First Capital India, a private-equity boutique, says this ranges all the way from big foreign funds negotiating equity stakes in large Indian public companies to Indian entrepreneurs returning from Silicon Valley to put their money into tech start-ups. "India is one of the few markets in the world that offers opportunities to deploy large amounts of private equity," says Mr Dalmia. Private-equity investment in India this year is expected to reach \$1.3 billion, up from \$800m in 2003.

China, which has no lack of capital and a tendency quickly to create overcapacity in any successful business, still has many foreign private-equity firms wondering how to make money there. General Atlantic Partners, long one of the savvier and more globally oriented American private-equity firms, has astutely teamed up with AIG, an insurer with great connections in Asia, and particularly in China. "We prefer to find partners in those parts of the world, as we would otherwise spend years trying to understand local conditions," says Steve Denning, General Atlantic's boss. Having started to invest in China and India three years ago, the firm this year floated one of its Indian firms, Patni Computer Systems, and recently bought a stake in GE's business-process outsourcing unit in India.

Carlyle and Blackstone, with TPG and Bain Capital following close behind, have decided to diversify well beyond private equity. This strategy is not entirely new. Many private-equity firms have long had mezzanine or distressed-debt funds. Blackstone has run a property fund since 1992. One reason for branching out is to provide a "one-stop shop" for limited partners such as big pension funds, which now want to reduce the number of private-equity firms they deal with, but without necessarily making their investments less diverse. Carlyle says it allows investors to pick and move among different market niches, and allocate capital across many funds without being charged the double fee that a fund-of-funds would incur.

Yet as firms concentrate on expanding their assets under management, they may start to care less about performance--which may anyway be affected by the sheer difficulty of evolving from "craft" businesses into huge institutions. And, say, Carlyle's 1-2% annual fees on the \$18 billion it manages add up to more than enough to provide its team of 280 investment professionals with a comfortable living even if their results are mediocre--which, to be fair, so far they have not been.

Is there any synergy between different sorts of so-called alternative assets? Blackstone, which tries harder than Carlyle to get its different sorts of fund managers to exchange ideas, says that, for example, during the tech bubble sceptics in its private-equity group saved its property group from investing in office space intended as cheap "telecoms hotels" for internet firms.

Yet even as Blackstone, Carlyle and TPG diversify, private-equity firms are complaining that hedge funds are moving on to their turf. Mr Kravis, noting that in the auction for Texas Genco the KKR club had only narrowly defeated a rival one made up of hedge funds, observed that "hedge funds know how to pick stocks and make a lot of money. But that is not the same thing as creating value through ownership of an asset over the long term in a hands-on way." Nor do hedge funds have the right valuation skills, say other private-equity bosses. One of them competed unsuccessfully for a stake in Air Canada against Cerberus Capital, a big hedge-fund firm. He reckons that, at \$185m, "Cerberus paid three times too much." Yet Cerberus is the hedge-fund firm most admired, and feared, by private-equity rivals.

Compared with private-equity funds, hedge funds are short-term vehicles from which investors can readily withdraw their capital, usually at least once a year. There is a risk that in the event of a run on them (and private-equity folk all agree that there is now a hedge-fund bubble), hedge funds might have to sell fairly illiquid private-equity investments fast. On the other hand, private-

equity firms, with their long-term perspective, have no obvious claim on the short-term trading skills needed to succeed in the hedge-fund business.

But if the buy-out side of private equity faces big challenges, much of the venture-capital business is having an even tougher time, as the next article will show.

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## Gut feeling

### Jack Welch on his latest job

"I WAS looking for work," jokes Jack Welch, explaining why he agreed to become a partner at Clayton, Dubilier & Rice (CDR). The much-admired former boss of General Electric surely had no shortage of job offers after he stepped down in 2001. But, he says, "today I see private equity as about as much fun as you can have if you like managing, improving assets, building leadership teams--which is what we do at CDR."

Mr Welch, one of several former bosses of big global public companies to move into private equity, was hired by Don Gogel, CDR's boss, to help get the venerable private-equity firm back on track after a few disappointments, notably an investment in Fairchild Aerospace. Mr Welch's main activity in his part-time role at CDR is to conduct in-depth quarterly reviews of all the firms in the CDR portfolio. He treats each management team to three hours of intense questioning and inspiration--a personal tutorial in the applied management philosophy described in his bestselling autobiography, "Straight from the Gut". The offer of regular meetings with a business legend may also help CDR clinch deals with managers of firms that have a choice of prospective owners. A call from Mr Welch can convince executives to work for, or join the board of, a firm that CDR owns.

Mr Welch used to conduct similar quarterly reviews of the firms within GE's diverse portfolio of businesses, helping to make the firm the exception to the rule that conglomerates underperform. "We do all the same things we did at GE--sit down with the CEO, look him in the eye, go over performance in the past quarter and plans for the next," says Mr Welch. "The only real difference between here and GE is we aim to sell the firm one day."

CDR is probably the most hands-on of the leading private-equity firms in its dealings with the companies it owns. It believes it can still add value, especially with Mr Welch's extra clout. Without the pressure most public companies feel under because they have to publish their results every few months, companies owned by private-equity firms can pursue longer-term strategies, says Mr Welch. CDR combines this long-term perspective with a strong emphasis on corporate governance. "If you don't bring governance, you are not going to be able to make it work." That is why CDR does not take part in club deals, he says.

Mr Welch's biggest challenge so far? At GE, he wanted to buy only good businesses. At CDR, he has had to "reset my brain to buy broken businesses and fix them". This has not been easy. "It takes a year to get into the right way of looking at these businesses. Your first reaction is, 'Jesus. Why would I want to get into that?' "

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## Once burnt, still hopeful

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### Has the venture-capital industry learnt its lesson?

#### European chill

THE contrast between the dream and the often disappointing reality of private equity shows up most clearly in the recent history of venture capital. Investors poured their money into the industry, certain that venture capitalists had discovered a corporate alchemist's stone, a quick and reliable way of turning bright ideas into valuable firms. For a while the industry's success seemed to prove them right.

Paul Gompers and Josh Lerner, in their influential 2001 book, "The Money of Invention", calculate that over the years, "venture capitalists have created nearly one-third of the total market value of all public companies in the United States." In 1999-2000, more venture capital was raised than in the entire previous life of the industry, stretching back to the 1940s. But when the resulting bubble burst, it wiped out investments of billions of dollars and killed off thousands of young companies, not all of them daft dotcoms.

Even so, the dream lives on, in America at least. Although investment in venture capital is well down from its peak, many experienced venture capitalists think it is still far too high. This means that many investors will probably be disappointed by the returns on their money. And the task of institutionalising and professionalising the erstwhile craft business of venture capital has become much harder.

Some of the investors who rushed into venture capital in the late 1990s have rushed out again, dismissed by venture veterans as "tourists and day-trippers". Most of the big industrial firms that set up venture-capital arms have either pruned them or lopped them off altogether. Many of the wealthy individual "angel" investors who provided seed finance for young firms have, in industry parlance, "gone to heaven": a lot of them were bubble entrepreneurs who thought they were richer than they proved to be.

Likewise, most buy-out firms have ended the flirtation with venture capital that led some to invest their funds directly in start-ups (as Hicks, Muse, Tate & Furst did, badly, in telecoms) and others to set up venture funds, such as KKR's joint venture with Accel Partners, a leading venture-capital firm. Conversely, the long-term trend for firms that started in venture capital (such as Apax, 3i and Warburg Pincus) to move into buy-outs has reasserted itself.

Even so, venture-capital firms may raise as much as \$25 billion this year, compared with only \$11 billion in 1997. "The amount of capital raised has come down, but it is still high by historic standards," says John Jagers of Sevin Rosen, a long-established venture firm that helped to bring on Compaq, among others. "At this level, the industry as a whole will not make money. It needs to be \$10 billion or less to get decent returns." At \$25 billion, he reckons, the industry as a whole may do no more than double its money, rather than more than trebling it, as it would usually hope to do. Given that top-quartile firms usually far outperform the rest, for the average firm an industry-wide doubling of the money invested, spread over the typical ten years, would represent a disappointing annual rate of return.

Certainly the influx of capital has brought much more competition to those parts of the economy that innovate through start-ups. For example, around 50 venture-funded firms are now said to be developing products to improve internet security, compared with the pre-bubble norm of 10-15 firms per sector. Clearly this is a recipe for many more corporate failures--yet many investors appear to have concluded that the bubble period is over, and that venture capital is likely to return to its former profitability.

## European chill

European venture capital got going properly only in the late 1990s and was just showing signs of becoming a serious industry when the bubble burst. That stopped it in its tracks. Biotech has been hit especially hard. "The biotech business model is changing here. A lot of VCs are moving away from early-stage investing to later-stage, near-market opportunities," says Sir Chris Evans of Merlin Biosciences, a venture firm that specialises in biotech in Europe. With firms like his now concentrating on investments likely to make money within one or two years, he says, "it is really hard for new, young companies to get early-stage funding in Europe now, and this is having a knock-on effect all the way to the universities, from where innovations usually arise."

Perhaps the bubble in Europe did not last long enough. "It was only really six months, much shorter than in America," says Anne Glover of Amadeus Capital Partners, a British venture-capital firm. This meant that "venture firms in America were able to get a lot more of their firms into the public markets and returned a lot of money to investors. Europe's didn't." That difference may help to explain why confidence in America's venture-capital industry has rebounded, whereas Europe's remain depressed. More broadly, says Mr Lerner, Europe lacks an "entrepreneurial infrastructure"--everything from law firms that specialise in venture to seasoned entrepreneurs and a liquid public market for young firms.

Will European governments try to counter the setback by stimulating domestic venture-capital industries? Some of them have tried before. Between 1965 and 1995, Germany launched over 600 government programmes to encourage venture activity, without obvious success. "The experience worldwide where government has tried to encourage venture capital has not been good," says Colin Blaydon of the Tuck Centre for Private Equity and Entrepreneurship. That is true nowadays even for America's initially useful Small Business Investment Company scheme, introduced nearly half a century ago to provide loans funded by the taxpayer. It became entangled in red tape, but has lingered on.

As new money floods into the industry, a disproportionate amount of it is going to the leading firms. In the buy-out business, well-known firms such as Forstmann Little that went awry have been punished by investors. By contrast, big names in venture capital that performed badly during the bubble period are still able to raise new funds; indeed, some have been turning away would-be investors. The latest funds raised by leading firms have all been smaller than their previous ones, and have been heavily oversubscribed, often two or three times. Kleiner Perkins Caufield & Byers raised \$400m, compared with \$1 billion last time; Sequoia Capital raised \$395m, down from \$695m. The only \$1 billion venture fund raised lately was by NEA, which does a lot more late-stage investing (and is thus closer to buy-out investing). But that fund, too, was only half the size of the previous one.

After a period when "epiphany replaced rigour", the leading American venture firms are going back to basics, says Scott Meadows, a former venture capitalist who now teaches at the University of Chicago. They are more disciplined in what they will finance, and try to ensure that they can walk away without a huge bill if the venture is not working, he says.

They are also rediscovering how important it is for venture general partners to mentor the entrepreneurs they finance, including taking seats on the boards of firms in their portfolio. The popular bubble-era idea of setting up "incubators" to bring on lots of companies fast and cheaply has been abandoned in favour of more tried-and-tested venture concepts. The best firms are becoming increasingly careful about what they invest in, and are doing more research before committing themselves. At the same time, some of them have become much more secretive about what they have invested in, in the hope of keeping down the number of imitators.

The top firms are benefiting from a virtuous cycle. Those venture capitalists with the best record of nurturing successful firms tend to attract the best ventures. A lot of entrepreneurs were badly treated after the bubble burst: venture capitalists allocated what money they had left to those firms in their portfolios nearest to achieving an exit, even if others had better long-term prospects. The idea was that if the venture firms returned at least some money to investors, they could quickly get on with raising a new fund. Even the best venture capitalists have upset entrepreneurs with their exit strategy; for example, Google's founders would have preferred to wait longer to do their IPO, but had to rush it because venture capitalists, including Kleiner Perkins, wanted to cash in.

The only serious threat to the growing domination of the leading firms is succession at the top, a problem discussed earlier in this survey. This is arguably even more critical for venture-capital firms than for buy-out firms, because the personality and involvement of the venture capitalist matters far more to a start-up than to a buy-out. Entrepreneurs increasingly want to know which particular partner will work with them before agreeing to a venture firm taking a stake in their business. Yet many leading venture firms, such as Kleiner Perkins and Greylock, have already made a number of successful inter-generational shifts, so the problem may be less pressing than in buy-outs.

Limited partners in venture firms are also becoming increasingly assertive. Kleiner Perkins, for instance, decided to let its limited partners off paying some of the capital they had committed to its worst bubble fund. "Over the next few years, limited partners are likely to be much more rigorous in holding general partners' feet to the fire," reckons Chicago's Mr Meadows. "They are not any more going to invest in funds where the general partner gets a distribution of cash before 100% of the limited partners' capital has been returned." During the bubble years, limited partners had to claw back a lot of distributions made to general partners when their funds proved to be less profitable than expected. It is all part of a broader attempt to make private equity more accountable.

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## Draw a veil

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### The attractions of privacy

#### The age of transparency

OVER the years, big financial institutions have replaced wealthy individuals as the most important category of company owner. With the rise of private equity, they now have two main ways of acquiring their stakes. They can buy shares directly in public stockmarkets, or they can invest in a private-equity fund that will, on their behalf, buy shares in private firms, or in public companies that they then take private. But which model is best?

Institutional investors typically invest well under 10% of their money in private equity, and some still steer clear of it altogether. But to hear people in private equity talk, its superiority over public equities is now overwhelming. Private-equity firms offer the best solution to the biggest problem facing institutional owners: how to ensure that their companies' bosses act in shareholders' best interests. With their hands-on corporate governance--from close but unbureaucratic monitoring at board level to carefully designed incentives for the bosses--they reckon they can deliver a better performance and steer clear of scandals. Corporate governance in the public equity markets remains notoriously weak, despite the increase in activism in the past decade, and particularly since the collapse of Enron in late 2001.

Indeed, the private-equity folk think that recent attempts by politicians and regulators to improve

public companies' corporate governance have further strengthened their hand. KKR's Henry Kravis has gone on record as saying that America's Sarbanes-Oxley legislation to tighten up public companies' corporate governance was a "positive development for shareholders. Today directors are taking their responsibilities to shareholders more seriously." But, he continued, "they are also being more conservative and risk-averse," and "to the extent that Sarbanes-Oxley causes public companies to be less competitive, there is an opportunity for the private-equity industry in taking these businesses private and putting some energy back into growing them."

There is no doubt that Sarbanes-Oxley and other legislation and regulation on both sides of the Atlantic have raised the cost of running a public company. Smaller firms, in particular, may feel that an extra \$1m a year in compliance costs, say, is enough to tip the cost-benefit analysis in favour of going private. Moreover, argues Larry Harris, who until recently was chief **economist** at the Securities and Exchange Commission, that is "not a bad thing". After all, if you take a firm public, "you have a high responsibility to the people who are trusting you with their money." The most expensive aspect of the Sarbanes-Oxley legislation, he says, is certifying financial results, which requires systems of accountability in public firms: "You need accountability if you are to have publicly distributed capital."

Mr Harris does not think that there will be any macroeconomic cost if there is a shift away from public to private equity. "If you can't raise money for a business idea in the private domain, given how much capital there now is in private equity, the idea probably isn't any good."

Yet it would be premature to celebrate the inevitable triumph of private equity. If most private-equity firms fail to improve their performance, investors may put their money elsewhere. And private-equity firms need healthy public markets as an exit route from their investments. Some leading private-equity bosses even hope to take their own firm public one day. They dislike private equity's long, secretive, inefficient fund-raising process, and the constraints imposed by each fund having a limited lifespan. They admit that the performance of publicly listed private-equity firms (such as Britain's 3i) has often been disappointing, but point to GE and Warren Buffett's Berkshire Hathaway, both of which have permanent capital and profit by doing lots of what are, in essence, private-equity deals.

And even if good exits are available, life is likely to remain tough for private equity as a whole, even as a few big firms and a larger number of niche operators do well. As Mr Kravis has said, many of the techniques that private-equity firms pioneered--paying managers with shares, concentrating on shareholder value, making good use of debt, maximising cashflow--are now standard practice in public firms, making it hard for private equity to outperform public equities. As they grow, private-equity firms may also suffer from diseconomies of scale, becoming more bureaucratic and risk-averse.

So institutional investors should look beyond the hype and question whether private equity really is a better bet than the alternatives. They are surely right to want to make private-equity firms more accountable, because they are not finding it easy to get general partners to accept responsibility when things go wrong. In 2002, the state of Connecticut's pension fund sued Forstmann Little for mismanaging its investment. The pension fund won, but was awarded no damages. It appealed, and Forstmann Little settled out of court for \$15m in September this year. Yet this was a pyrrhic victory. In the words of one private-equity veteran, "The only funds that will take Connecticut's money in future will be those that can't raise money from anyone else." That is quite a penalty in an industry where the best funds far outperform the rest and are able to pick their investors.

A similar punishment was meted out to some public pension funds, notably CalPERS, which last year published the results of the private-equity funds in which they invested. They were only trying to comply with the disclosure requirements of freedom-of-information legislation, but

several funds--led by Sequoia, a top venture capitalist--said they would no longer accept money from public pension funds. Some states have since modified their laws to limit the need for such disclosure.

Limited partners are trying to exercise more clout by setting up organisations to represent their collective interests--though the people heading such groups are habitually poached by private-equity firms just as they start to find their voice. Some pension-fund managers responsible for investing in private equity hope to go on to much better-paid jobs in private-equity firms, so may be slow to criticise them for fear of marring their prospects.

Perhaps the growing fund-of-funds industry, led by firms such as HarbourVest and Parthenon, will eventually make a better job of holding general partners to account, not least by encouraging the development of a liquid secondary market in limited partnerships. So far, however, funds-of-funds have stood out mainly for their additional fees.

More accountability will require better information about the performance of private-equity portfolios. As things stand, valuations are a shambles, says Colin Blaydon of the Tuck Centre for Private Equity and Entrepreneurship. Valuation methodologies are not standardised and tend to be overly conservative, using historic cost rather than current market value; and values are rarely reduced when they should be, and are easily manipulated by general partners. But industry groups are slowly making progress with standardising valuation methodology. Herman Daems of the European Private Equity and Venture Capital Association (EVCA) points out that Europe is now well ahead of America on standardising valuations and reporting.

### The age of transparency

Government, too, is getting more involved in trying to make private equity more accountable and transparent, either through freedom-of-information legislation or via attempts by watchdogs such as the SEC to regulate the industry. The SEC has hinted that, having started to regulate hedge funds, it may turn to private equity next.

Even with the lobbying expertise of industry groups such as the EVCA, the British Venture Capital Association and America's National Venture Capital Association, it is hard to believe that private equity will be able to escape the growing pressure for institutions of every kind to be transparent. In many respects, greater transparency should improve the performance of private equity by making such firms more accountable to institutional investors--who, in turn, should then be more easily held to account for their investment choices by the public whose money they invest.

Yet transparency can go too far. Private-equity firms may be wrong to oppose attempts to make them disclose the performance of a fund as a whole at frequent intervals. But they are surely right to resist disclosure of the performance of each firm in a fund's portfolio. The one big advantage that private equity still has over public equities is that it can transform firms away from the public gaze and from the short-term pressures of the stockmarkets. Imposing full transparency on the kings of capitalism would destroy this advantage. As Walter Bagehot, a great early editor of The *Economist*, famously observed about the British monarchy, "Its mystery is its life. We must not let in daylight upon magic."

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