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The (Not So) New Game In Private Equity

Why Leadership Matters More Than Ever

by

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A Very Brief History of Private Equity

The origins of today's private equity industry (which I would define as including both venture capital and leveraged buyouts) date to 1946 with the foundations of American Research & Development Corp. (ARDC) & J. H. Whitney. Prior, risk capital had almost exclusively been the domain of wealthy families. Venture capital pioneers Mayfield and Kleiner Perkins were founded in 1969 and 1972, respectively. In the buyout realm, the origins of LBO pioneers KKR began at Bear Stearns with "bootstrap" investments in the early 1970s, forming the foundation of the firm as we know it today. TH Lee; Forstmann Little; Welsh, Carson, Anderson & Stowe; and GTCR were all in operation by 1980 and became major players. The modern private equity business continued to emerge in the 1980s with the realization that there were major discrepancies between public company management interests, the age old "agency problem" and the values that could be unleashed were business units to be decoupled from large public companies. The year 1980 saw some $2.5 billion raised dedicated to the emerging alternative asset class and in the decade that followed nearly $22 billion was raised by venture and buyout funds.

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The wide availability of junk bond financing fuelled a boom during the 1980s, followed by a crash as the stock market tanked in October 1987. High yield financing, or "junk bonds," dried up for a time, and Drexel Burnham, the leading purveyor of these instruments, later went down. However, institutional investors had certainly picked up on the higher returns available to PE than in the public markets.

Key to these were the availability of debt financing, the disparity between management that were merely salaried and those that were incentivized by equity, and the discrepancy between public and private market information. For much of the next two decades private equity vastly outperformed the public markets. Clearly, the emergence of technological innovation in software, semiconductors, and telecom fuelled the venture side, while widespread industry consolidation and globalization largely propelled the LBO market.

As ever more money flowed into pensions and other institutional investor funds, the demand for higher yields accelerated. This put more capital into the financial markets seeking higher returns and the boom continued. Of course, there were blips and shocks, including the Foreign Debt crisis of 1997/98, the bursting of the dotcom bubble around 2000, the cessation of normal market activity following the 9/11 attacks, and perhaps most seriously, the major Financial Crisis after the collapse of Lehman Brothers and Bear Stearns in 2008.

However, markets rebounded, time and time again. Institutional capital, which seems to have a short collective memory, always seeks ever higher levels of Alpha (relative return) and will accommodate Beta (risk), often in unison, seemingly without independent, objective decision-making.

Institutionalization & Growth of the PE Industry

Funds were usually (relatively) small and privately held, and made individualized, partner-driven investment decisions. Yet as their size has increased, and in many cases the larger funds went out to the public markets, the industry has fundamentally changed. Now publicly traded, firms like Apollo, Blackstone The Carlyle Group, and others are, as the co-founder of one confessed to me "No longer in the business of making extraordinary, outsized returns on unique investments. We are now in the asset management business. If we can beat the S&P by 150 basis points and put huge sums to work from institutional investors, we are happy and the investors are happy." With the traditional model of a 2% management fee on assets under management (AUM) and 20% capture of the return on investment, the carried interest, who would not be?

Where a billion dollar fund was once considered a large player, there were over 350 by 2018 and even more today. There has been a veritable explosion in investment in the sector, as uninvested cash, or "dry powder" at PE firms exceeded $1.5 trillion by the end of 2019. Blackstone alone, the *Wall Street Journal* reported, had $150 billion in cash to invest at the end of last year. *Institutional Investor* reported in July 2019 that 4000 funds were seeking to raise an additional $980 billion, up from 1385 funds seeking to raise $417 billion just four years earlier.

Yet in the 2010s the number of publicly traded companies stayed roughly the same while global AUM for PE firms and the number of PE-backed companies doubled, according to McKinsey & Co. It comes down to simple economics as more money is chasing fewer good assets, hence driving up prices, and reducing returns. *S&P* reported in November 2019 that the average pro forma EBITDA multiple was 12.9, up over 30% from pre-Financial Crisis pricing. The massive leverage, low prices, and eye-popping returns of the 1980s are but a memory. What is a simple fund to do?

Adding Operating Expertise

Importantly, funds have changed their own internal structures over the last several decades. Almost no funds had seriously tenured operating executives as part of their investment teams in the 1980s, being almost exclusively comprised of "recovering investment bankers." The 1990s saw a bit of a change, but now almost every major fund has hired people who have more than an investment banking/finance background and have been senior operating executives who have actually run P&Ls. In many cases these are actual full partners in the funds, as the Silicon Valley venture capital community was quicker to adopt this model, typically by adding tech CEOs to their rosters, than the Wall Street LBO community. Many are termed Operating Partners or Management Associates, but whatever the nomenclature, there has been a collective recognition that strictly financial engineering and financing skills are necessary, but not sufficient, to create outsized shareholder returns.

Most of my clients and many of my good friends are private equity professionals. Without naming names, an informal survey confirms the general thesis that by training they are not prepared to run the businesses that they buy. Increasingly they recognize these facts, despite being "the smartest person in the room" on virtually any topic (sic), in the not so distant past.

Where Are We and Where Are We Going

Fast forward to today, the late 2010s and early 2020s. The game has changed significantly, to say the least. Not surprisingly, many of the factors that led to the tremendous success of the industry in years past have changed dramatically. There is a changing reality and investment firms have, with varying degrees of success, made adjustments.

For example:

Financial engineering is no longer adequate. Given the low interest rate environment of recent years, and explosion of alternative lenders such as credit funds, beyond the traditional large banks, a giant fund enjoys little advantage over a smaller one on the availability of financing or borrowing terms. And, let's face it, even if KKR or TPG can borrow at 25 basis points lower and with slightly less restrictive covenants than XYZ Capital Partners can, that factor alone is unlikely to be the deciding factor between the success or failure of an investment.

Globalization of the industry. Where venture capital and leveraged buyouts were virtually exclusively a US phenomenon just a few decades ago, today according to various studies, only about 55% of global private equity activity is in North America today. While Africa and Latin America are somewhat underrepresented, Europe and Asia are booming in this respect and the former may well catch up

Operational excellence, coupled with the genuine ability to inspire, will always be valued.

over time. It has become, as in so many industries, a much more competitive, truly international playing field.

Ubiquity of information has changed the game. The asymmetry of information that led to smart buyers and uninformed sellers is simply no longer the case. The incredible proliferation of information and ease of access on a global basis means that sellers, even of relatively small and unsophisticated businesses, have a much better handle on the overall market than in the past. An investment banker friend and I have a running joke that Old Uncle Burt, selling his cornfield in Iowa, knows that he can command 7.8 to 9.3 times EBITDA these days and will have five buyers lined up! In short, because of this the market is much more ruthlessly efficient, further evidenced by the dramatic expansion in the number of deals done and in the ever higher multiples paid for them.

The Model Still Works. The increased volatility of public markets, however, continues to make private equity attractive. What was once termed an alternative investment is certainly now very much in the mainstream for most sophisticated investors. However, the delta in returns between public markets and private markets have flagged in the last several years. As Bain & Co. noted in its *2020 Private Equity Report*, "10-year public market returns match PE returns for the first time."

Yet the current crisis, at the same time akin to the ones we seem to have every five or 10 years, and on the other hand of unprecedented scope, has obviously put an enormous dent in the wealth accumulated in the stock market. The ability to be patient and not have to respond to quarter-by-quarter earnings can allow private equity investors to take a more strategic, long-term view and ride out much of the fickle fluctuations of the financial markets.

This may seem a bit ironic, since most PE funds would love to be in and out of investments in a 3 to 5-year timeframe if possible. But with the public markets bouncing as violently as they are, private equity will remain a very attractive industry, both for Limited Partners as institutional investors and General Partners, the PE funds, as the custodians and direct investors of those funds.

Executive Leadership Matters, Now More Than Ever

Over time, more and more funds have gone to a model of backing individual executives or executive teams in what I call the "Back-able, Bankable Leadership" model, or BBL. Both venture and buyout funds have increasingly backed executive leadership that has had prior success and will continue to do so. The proverbial "Holy Grail" for investment funds is to find management teams that are proven and have as close to a proprietary idea as possible. By this I mean either a specific target company(ies) for acquisition or a well-developed investment thesis with demonstrable potential acquisition targets.

How much better to create a situation where you have an organic genesis of an investment, rather than competing in a broad auction scenario against many other funds. In the latter case, the "winner" of an auction may be successful in acquiring a business, but a loser as an investor, having paid too high a price at the outset.

An old saw in investing circles is that "You are more likely to win by backing an 'A' management team with a 'B' plan over a 'B' management team with an 'A' quality plan." At no time has this been more true than today, as many firms actually have to reinvent their business models on the fly. As we face unparalleled turbulence in the markets, especially given the latest crisis, never has leadership, true leadership, been at more of a premium. Operational excellence, coupled with the genuine ability to inspire, will always be valued. In short, today it is more critical than ever to actually run businesses better.

Effective executive leadership makes all the difference. It certainly makes me quite sanguine about the prospects for the executive search industry in partnering with private equity clients to create value. Successful investors invest in superior management and leadership, especially when competition is greater than ever and times are uncertain, to say the least!

About the Author: **Kerry Moynihan** specializes in partnering with boards of directors as well as private equity firms and the C-suite executives of their portfolio companies to deliver for investors.

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