Limited Partner Roundtable: Outlook for Private Equity

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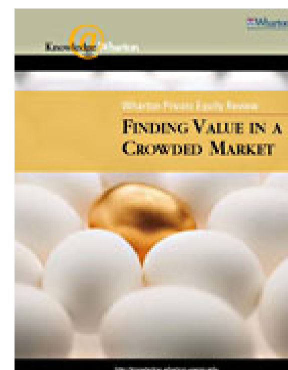

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To take the pulse of the private equity industry, members of the Wharton Private Equity Club (WPEC) coordinated a roundtable discussion between four leading limited partners representing, in total, well over thirty billion dollars of alternative asset buying power:

***Kristin Gilbertson** is Chief Investment Officer of the University of Pennsylvania, a role she assumed in 2004. Previously, she was managing director of public equities at Stanford Management Company.*

***Sandra Pajarola** is a partner and private equity investment committee member at Partners Group in Zug, Switzerland. She leads primary private equity partnership investments for the firm.*

***Cory Pulfrey** is managing director and co-head of Morgan Stanley Alternative Investment Partners. He previously served as managing director of the Weyerhaeuser Pension Fund Investment Group where he managed the global private markets investment program. He is a Wharton alumnus and a member of the Wharton Private Equity Partnership Advisory Board.*

***Michael Taylor** is a managing director at HarbourVest Partners, currently focusing his activities on primary and secondary partnership investments in venture capital funds. In earlier roles at HarbourVest, he also managed direct co-investments. He is a Wharton alumnus.*

WPEC: From your perspective, what's the outlook for general partners? What are some of the main issues you expect them to face in the next few years?

KG: One of the things I would worry about is that there is a change in the alignment of incentives. So in the old days when you raised a small private equity fund, you really made your money on the carry (the percentage of profits that the fund partners get to keep). If you only [managed] a billion dollars, you weren't going to get rich on the management fees. As these businesses have grown, the management fees have grown substantially. So the alignment -- where traditionally 'you only get rich if you make me rich' -- has changed. On the other hand, you have to pay up for talent, and many of these people have made tons of money for Penn and their other investors, so I would say, don't begrudge fabulous investors the fees and the carry.

SP: Hopefully most [fund partners] are motivated just by the business so it's not the money; they will just keep going and they just love it, it doesn't matter if its $20 or $200 million. What we might start to see are some that say, this is enough. I don't need more so now I can retire. And I don't think we've seen that happen already to any great extent in Europe yet. I think we might see more of that.

CP: There is also a very strong market these days for talent. Hedge funds are taking private equity guys and private equity guys are leaving to start their own funds. Keeping talent is a bigger issue today in private equity than it was three to four years ago. It can be at any [job] level, and is often times driven by

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how the rewards are distributed.

SP: I think it will sort itself out. I think private equity and hedge fund people are very different by nature. And I think people will find their balance where they belong. Yes, on the hedge fund side there is higher compensation but there is also higher risk of hedge fund falling apart. And when you look at the life of the hedge funds and how long they last and how many last, and private equity and they are very different numbers. I don't see this as a problem. Yes many people are driven by money but also they are driven by what they want to do.

KG: Managing growth is [also] a very challenging thing, and it's one of the things we look at with all of our [external] investors, be they private equity, hedge funds, real estate, or public equity fund managers. The founders need to bring in the next generation and coach, mentor and promote them, but how do you manage that process of growth so that you don't have too many people itching to do deals and lose discipline?

WPEC: You've all just talked about internal issues, questions that GPs face with respect to their organizations. What about external issues? What's important in the investment environment these days?

KG: Buyouts have benefited from easy credit. Spreads are low, interest rates are low, and covenants on loans are absent. It's a wonderful environment to leverage up. We've seen a lot of private equity shops execute some very good deals and subsequently dividend recap those deals for a very nice IRR (return). [*Editor's note: a dividend recap is when a company raises debt and uses the proceeds to pay dividends to private equity investors.*] But that environment is not going to persist forever. I am concerned that some of those same companies where we've seen spectacular returns may suffer if they're in cyclical industries. Some of these companies are going to experience some earnings volatility. What happens if they're perhaps over-leveraged? How do the private equity shops deal with that? What happens if the markets somehow seize up and you can no longer refinance? Private equity shops have certainly benefited from credit market conditions but that easy credit can go away and I think that will make it more challenging for private equity shops in the future. It's been a perfect storm in a positive way. You've had easy credit in a rebounding economy and greater consumer confidence with better exit options in the public markets, and those conditions may not persist. That's very important because right now everyone is raising a lot of money and fund are getting bigger by multiples. There's a lot of money chasing deals, and if the environment tightens up, there might be more competition for deals and we may see some investors lose discipline. I think one of the issues they will face is that having raised larger funds, and there now being much more capital out there, and having grown their teams substantially, they're going to have to exercise considerable discipline, which is hard to do when you have a lot of money burning a hole in your pocket.

WPEC: That's a vivid picture of the buyout market. What about venture capital?

MT: In venture, if you are not a well known GP, it's really tough to get a fund raised. First time funds or less well known GPs or having a tough time in the market. If you are a brand name, particularly [on the] West Coast, it's a different story. There's a widening gap between the rich and the poor or the experienced and the inexperienced.

KG: Not all investors are created equal!

Hedge Fund Convergence

WPEC: One of the most talked-about issues facing GPs, which we haven't yet talked about, is whether the private equity industry is colliding with the hedge fund world. Have you seen any evidence of this?

CP: You always had some overlap on the GP side in the distressed area between hedge funds and private

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equity, but it is becoming more material these days. In the past, a fund would be either hedge funds dabbling in private equity or private equity fund dabbling in more liquid, distressed investments. Nowadays, the trend is that hedge funds focused on distressed in the past are now doing more illiquid, private equity-like strategies.

SP: Private equity GPs look to the compensation structure of the hedge funds. They are envious and would love to build in yearly compensation as opposed to having to wait five to ten years for carry. Hedge fund GPs are allocating twenty percent [of their funds] to non-liquid assets so they can really start dabbling in private equity. You see them tremendously in the debt markets, and on the mezzanine side. They They are also dabbling on the equity side to see if this is a place they really want to be.

CP: Another, new trend is hedge funds doing buyout transactions -- plain vanilla ones. That convergence model is probably not as robust as compared to the distressed side, because hedge funds are not generally as experienced working with companies to effect change compared to private equity funds, and when hiccups happen, there is a greater chance that they would have issues as opposed to the guys with long-term private equity experience. We are seeing a clear trend by some funds, for example Carlyle and Blackstone, in becoming broader alternative asset platforms. Those two in particular are doing private equity, hedge funds, hedge funds of funds, and real estate. That trend will continue because investors who are familiar with the brand are just comfortable with the group and are going to take a look at other types of products.

MT: There's a lot of synergy on the fundraising side given that at most institutions, the decision maker in charge of alternative assets, invests in both private equity and hedge fund managers. If you like the hedge fund manager and believe in their ability to grow the management company, why not ask them to raise a private equity fund or vice versa? But I would be somewhat suspicious of these groups that try to do too much under one management company. It makes sense logically, it's like Marketing 101 in that you want to extend your brand. The rub is, can you find the right people who will fit into the organization and not create cultural issues? Do you want your brand associated with another asset class? The view here is, let's stick to our knitting.

KG: The way we're structured [at Penn], is that we have a managing director of private equity and a managing director of absolute return, so it is two separate things. But as in all organizations, you need to have people who are specialists in what they do, but there will invariably be overlap. We're a small enough team that we're all in the same office and we can all talk about what makes the most sense.

Distressed Debt

WPEC: It seems as though one of the mains points of convergence is in distressed debt. Do you think this will ever be a large enough to be considered a sub-asset class in private equity, along with venture and buyouts?

SP: I think there would have to be a fundamental change in the amount of debt for it to be really its own area, to come out of its niche. By definition distressed debt should be a small percentage of the total amount of debt, there could be times it is higher, but by definition it should be a small amount. There might be short shifts, and equity levels have come down in the recent years. But it hasn't been that significant; on average it has gone from 35% to 32%. That is not a big shift. So despite all this talk about debt markets, people have been very prudent about the amount of leverage they are using on deals. You have to put in longer term perspective. It's not going back to the 1980s. Yes, I think there will be one or two deals that struggle and they will miss their covenants and have to renegotiate. But it's not absolutely crazy. I don't see a fundamental shift of distressed debt stacking up to buyouts, venture and mezzanine in the long term. Rather it will always be a niche area.

KG: I think distressed funds already are a viable third pillar of the private equity world. The issue with

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distressed is that it is a cyclical business. There are better times to invest than in others, and sometimes, there's just nothing to do. But I think that sophisticated investors have always looked at distressed and it's one of the things that I'm excited about going forward. I don't know where we're going to have an opportunity to invest in distressed -- it may come in CDOs (collateralized debt obligation funds), or it may come in private equity deals with lots of leverage... there may be another Enron. We don't know where it's going to come but we do know that it's likely to happen if not this year, maybe in two years, maybe in three years.

CP: I think it is cyclical. I think there is always a level of secular distressed opportunity that is present globally, but the opportunity is much richer at certain parts of the macro cycle. But during that whole time we were investing in distressed, in general we found opportunities throughout the cycle but the opportunities really differ in different years. I first started investing in distressed in the early nineties and it was pretty clear at that time given the slowdown of the economy, that there was an opportunity there. That is really when the industry started. We believe there is a good probability there is going to be a lot of distressed opportunities in the next year or so.

New Horizons in Venture Capital

WPEC: What changes are you seeing in the venture capital industry? Are there new sectors that the top tier firms seem to be pursuing?

MT: What is new may just be old. IT and healthcare has been the bread and butter for the venture sub asset class. But there is a return to older, recently out of favor, sectors. Several venture funds are now doing consumer deals again, which is what they were doing twenty years ago. That could mean restaurants or retail or internet services, but the emphasis is definitely on the consumer. It's a new spin on the old, in the search for high growth opportunities. Three-four years ago people were talking about nanotechnology, but that is still twenty years out, which is still too far out for a ten year fund.

WPEC: How about alternative energy? Is that a viable sector specialty for professional venture capital?

MT: Alternative energy has been very good to us over the last two years. We were acquiring alternative energy assets in Europe at very cheap prices prior to the run up in oil pricing. It appears that there is no easy or short term fix for our fossil fuel woes so alternatives will probably continue to be an appreciating asset class. Not to say that a lot of these funds can't do well, but everyone raising a clean tech fund is getting traction from the backlash of high oil prices, Bush's energy initiatives and recent alternative energy subsidy announcements in California. I don't know how big it is going to be but alternatives are a small amount of the overall energy market. Even a ten times increase in Solar for example, would still be immaterial to the overall size of the global energy market.

KG: I'm intrigued by renewable energy and clean tech, certainly because oil prices are so high today, it has brought heightened awareness to our dependence on oil, and that has implications for the economy, for national security... I think some of these areas are truly exciting in the same way that IT was exciting and new and different and revolutionized our world over the last two decades. So I think that it's only natural that the venture community reaches out to the next 'new new' thing. We'll see which of these areas it ends up being.

WPEC: Kleiner Perkins just hired Colin Powell. What do you think are the prospects of homeland security as another potential new sector in venture capital?

MT: I think after the initial shock of 9/11 wore off, managers [focused on homeland security] are finding it hard to get funding out of the government for projects that once seemed interesting and a security necessity. The focus really shifted to the war in Iraq, so that's where the spending has occurred with the military contractors. Homeland defense has actually been quite disciplined in how they go about

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allocating capital, so there hasn't been a lot of success on a large scale in the security area.

WPEC: Any developments in the way that venture capital firms are investing?

KG: I think one of the other interesting trends to emerge out of Silicon Valley is an increase in stealth investments. You're not seeing all the [venture firm's] investments on its website. They're trying to incubate those deals for longer, and that's a sign of competition for deals, not so much competition to get into a particular deal, but that company that's being incubated also has to worry about competition from other startups. So stealth is becoming increasingly a tactical tool in the venture capital business.

International Markets

WPEC: There's a lot of talk about international private equity lately. What's new?

CP: A real venture community is emerging in Europe, and that's going to be an opportunity. Israel has a material and growing venture industry, including a number of world class venture firms.

WPEC: Many observers are focused on private equity in emerging markets. Is this hype, or is it real?

KG: There's a lot of discussion of India and China, and certainly India and China are very exciting growth stories with hundreds of millions of people who have lifted out of poverty into the middle class, creating whole new markets and also some fabulous world class companies.

SP: I think everyone likes the macro story. But what is different [from developed markets] is you can't tell who the true winners are. You can't look back on a long history and say they have proven it over three cycles. And so everyone is using their due diligence to make guesses about who is going to be the winner. And it's not so clear.

KG: There are going to be more of those world class companies created in India and China and other countries going forward. But one of the challenges that we face is there is a real lack of institutional quality investors. I think it's also instructive to think of the story of Infosys. Infosys was founded with the savings of these men's wives and there was no venture capital involved in this company and it's a huge multi-billion dollar success story.

MT: We are skeptical about what's going on in China, particularly with venture. It seems that everyone is focused on it but that just may be the press blowing it out of proportion. This is the third or fourth time that we've seen this story and we still believe that the fundamentals are not in place. As a firm evaluating Asia-Pacific opportunities, we find comfort in Asian buyouts, which are still relatively new in the overall scheme of things. We have had good, consistent returns there for the past ten to twelve years. There are now teams with track records of two or three funds, with little investor turnover, staffed by local talent instead of a bunch of ex-pats.

CP: Our experience in Asia in the last few years has been quite good. But you run into issues that you are not running into in developed markets, like legal and regulatory issues, integrity issues, huge macro swing issues that in illiquid situation can take you to zero, with Russia and Argentina being examples of funds losing a lot of money in the mid-nineties.

WPEC: What if you had to choose between India and China today? Which provides the better opportunity for long-term private equity investment?

CP: We are invested in both India and China. India has a better developed legal and regulatory system.

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India has a stronger need for external capital than China given their relative internal and affiliated resource bases. But I don't know which country is better positioned for private equity successes in the next ten to fifteen years. We have high hopes for both countries but we approach both cautiously based on our historical experiences.

KG: There is certainly money to be made there and value to be created there but I think many of these venture investments won't return capital. I think the foundation and endowment community is very active in investigating the market and planting a few seeds to gain information so that as the market matures, we are there. It's tough to be institutional quality when you're in an emerging market.

Words of Wisdom

WPEC: So, in closing, what advice would you give to the present and future private equity GPs reading this article?

KG: Well, particularly for newly minted MBAs, training is vital. This is an apprenticeship business. I would not be quick to take the highest offer or the flashiest title. I would research where you're going, who you're going to be working with, and the quality of the organization. View your career as a long term investment, and go to a place where spend five or six years getting trained with someone who is a top quality investor.

SP: No matter what kind of fund you go into, small cap in the US or venture in Asia, whatever it may be, it's global no matter what you do. For example a small cap fund in Italy, very small cap, has an office in China because they have a lot of manufacturing companies in their portfolio outsourcing to China. So wherever you are, it's global. And you always have to have the global perspective.

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