

Private Equity Heads Down a New Path

The general approach towards private equity investments has shifted substantially, in part to conform with the tougher market conditions prevailing after the financial shocks of the last few years. Gone are the days of earning profits largely through financial engineering and rapid portfolio turnover. In their place — business transformation — where investors park their money for longer terms and generally rebuild under-performing companies. Wharton professor Stephen M. Sammut and Philip Bass, global private equity markets leader at Ernst & Young LLP, discuss the new landscape in this Knowledge@Wharton podcast. They also take a look at the similarities — and differences — between private equity specialists and entrepreneurs.

An edited transcript appears below.

Knowledge@Wharton: We're speaking today about how private equity is changing with Stephen M. Sammut, a senior fellow and lecturer at Wharton, and with Philip Bass, global private equity markets leader at Ernst and Young. Our topic: how private equity (PE) has shifted dramatically since the financial crisis. The days of earning profits through financial engineering and rapid portfolio turnover seem unlikely to return in the foreseeable future. In its place is what's being called "business transformation," where investors park their money for longer terms than they used to, and where value is being generated fundamentally by rebuilding under-performing companies. Is this an inevitable maturing of the industry — was this development going to happen anyway, and is just coming faster because of the financial crisis? Or, did the crisis change the nature of the business?

Stephen Sammut: I think it's an important question. I believe most private equity professionals in the United States and Europe would agree that it accelerated what was an inevitable change to be. On the other hand, the disciplines associated with leverage buy out and financial restructuring, financial reengineering and recapitalization were so finely developed, and for the most part were working well enough, where I suspect most professionals and most of the PE funds were reluctant to make the change more towards operational engineering and strategy refinement. But the financial crisis — we still speak

of it as if it were immediate, but we're five years post at this point — did change fundamentally the availability of leverage and the way deals could be structured. So as a result there has been more emphasis on the operating aspects of companies.

Now notice I said the United States and Europe, because in the emerging markets, by contrast, financial engineering was never really a fundamental part of the strategy. Leverage in very few markets is available the way it was in the U.S. and Europe. And the emphasis there really had to be on reorganization — restructuring in those instances where funds were able to take controlling positions. In those instances where they were taking minority positions, for example, in family run enterprises that were seeking additional capital, they would take even more subtle approaches to influencing change and growth in companies.

Philip Bass: I agree 100% with Steve. When we look at private equity over the last couple years, especially in the downturn, there were people that didn't think private equity was going to make it. And the exact opposite has happened. Private equity really rolled up their sleeves and worked hand-in-hand with their portfolio companies to transform those businesses and position themselves, those portfolio companies, for success.

There surely was some element of adjusting the capital structures — but all in all, it was really

around business transformation, and the focus on organic growth and value creation, which is what got a lot of the portfolio companies to where they are today.

As Steve said, private equity makes money off of three things: the use of leverage, rising multiples and business transformation. We've done an exit study in the last five to six years, both in the U.S. and in Europe, and what rises up out of that, especially when you take a look over the five and six year period, is that it's really business transformation which is the largest driver of growth. With leverage down now and not getting the lift from the overall market, we don't think that's going to change going forward. So when we look at the future, we believe that it's going to be this ability to transform businesses that is going to make or break private equity. And we think that private equity has done quite well in adapting to the environment over the last couple years — in positioning themselves to be successful going forward.

Knowledge@Wharton: Private equity specialists and entrepreneurs are said to have much in common. Both thrive by being creative and resourceful, and able to spot opportunities earlier than the pack. Entrepreneurs start companies from scratch, however, and private equity specialists take existing companies to the next level. How are these mindsets similar and how do they differ?

Bass: We put out an annual industry piece called our *Global Private Equity Watch*, which takes a look at the last 12 months, but also takes a look out in the future. And in preparing that this year, we did some research around this exact question and ultimately concluded that the traits of an entrepreneur are very much like [those in] private equity — for example, having drive, tenacity and persistence. You're really talking about the persistence [when you talk about] private equity's ability to work through the downturn. Another [example]: Seek out niches in market gaps. Again, private equity is continuing to both look at market opportunities, geographically as well as business

opportunities, in different sectors and industries. [Another similarity] is the diversification of their model, from a sector as well as a geography standpoint. And again, as Steve said, the emerging markets are becoming a bigger piece.

Another trait [both have in common] is building an ecosystem of finance, people and know-how. We've seen the private equity funds invest quite a bit in the back office to really support the increase in interactions with the regulators and LPs (limited partners). So, it is this concept of continuing to build their ecosystem of people, process and know-how. Part of that also is the building up of the operating partners and portfolio support teams — building out their support model for private equity.

Knowledge@Wharton: Some of those things sound like a menu for good business practices in general. Steve, I'm wondering what your view is on this and how they're similar or different?

Sammut: One thing that is certain is that the financial disruption did force private equity shops, and the same holds true for venture capital, to become much more institutionalized and organized than they had been. In many instances, and this is an exaggeration, this resembled more cottage industries than organizations that were managing hundreds of millions, if not billions, of dollars.

It is absolutely true that they have become far more organized, sophisticated, and have invested more of their management fees in building out the internal infrastructure needed to be truly viable businesses. And I would agree that many, if not most, private equity professionals do share a lot of traits with entrepreneurs.

What I suspect, though, is that entrepreneurs don't perceive private equity professionals as being kindred spirits. In fact, although the relationship may be unfair to characterize it as adversarial, I think if you were to poll entrepreneurs, they would not see much of themselves in the way private equity professionals do business. And I think the differences have to

be that these days the PE professionals have to operate with a level of precision, persistence of course, but with a level of precision and sense of reorganization that the entrepreneurs generally don't see. There's also, I think, very a substantial difference in the way they would perceive the role of control in companies. We could probably talk about this for an hour or more. But yes, in terms of academic literature and the classic characteristics of entrepreneurs, I think you would find them in PE professionals. But I'm not sure the twain shall meet.

Knowledge@Wharton: Many emerging markets are expected to grow at twice the rate of developed markets over the next 30 years. Everyone's familiar with those kinds of statistics, thanks to young populations, a growing middle class with disposable income — all the usual reasons. Where will the best opportunities lie though, not just with the BRIC [Brazil, Russia, India and China] countries, which people are very familiar with and expecting great things from, but also in the group behind that, the frontier group of markets — like Africa or countries like Turkey, Indonesia, Vietnam, South Africa, Mexico, Chile and Peru?

Sammut: All of the above. There has been very significant growth beyond the bricks in private equity. Africa as a continent alone. Heretofore, when we thought Africa we thought South Africa, and that is no longer the case. There are at least 50 viable, meaningfully sized private equity funds operating in Africa right now, throughout the continent. Kenya, Nigeria, Tunisia, Egypt and South Africa are enjoying a great deal of it, but it's fairly widely disseminated and I think that growth will continue. There's certainly a lot of positive mindset. Funds are springing up in Turkey and Indonesia and Vietnam. The latter two, particularly Vietnam, would not have been really on anyone's radar screen five years ago. And you've mentioned Peru and Columbia. There is a proliferation of funds in both of those countries.

What's driving it? As you say, the expansion of the middle class, but what is really going on is

that many of the companies in those markets, in efforts to expand their markets and become globalized, need additional capital. And traditional sources of capital like banks simply aren't there to meet the need, creating an opportunity for private equity funds and a willingness by entrepreneurs and by the business owners to think differently about what their relationship to a source of capital will be.

So yes, it's the macro environment that's driving it all, but it's also the realization by the entrepreneurs that they have to do business differently and seek capital in alternative ways, and it's allowing the PE funds to step in.

Bass: I agree. We expect to continue to see growth in the BRICs, the emerging markets as well as the frontier markets. At the end of the day what we're looking at here is a diversification strategy for each of the larger PE funds around investing in the countries with higher GDPs. And, ultimately, that can translate into higher returns and incorporating that into their investment strategy along with more mature markets. So, we would expect to see continued investment in both the emerging as well as the frontier markets. And all the markets that Steve mentioned are on the radar of many of the private equity firms.

I would also agree 100% with the concept of entrepreneurship. Having just been down in Brazil for a week, most of the private equity transactions in the market are not the typical LBO (leveraged buy-out) model. They essentially are private equity teaming with entrepreneurs, making minority investments, less than 50% investments, and teaming with the entrepreneur to drive growth. So, it's really around helping the entrepreneur grow the company and position it for success. A lot of the things that Steve said I agree with and I'd expect both the frontier markets to increase in importance to private equity as we move forward.

Knowledge@Wharton: Would each of you name a couple of sectors that you think would be particularly interesting in different regions?

Sammur: Not to be flip, but almost anything. But in particular, depending on the markets you're looking at, plays in education are actually rising just about everywhere as families look for alternative ways of educating their children, and preparing them professionally and for trades. There is an increased attention to health care, which is largely driven by the demands of middle class to go beyond the publicly provided health care facilities in most countries to privately provided care. So those are two. But you will see in industries that we would consider very basic or fundamental in the U.S. or Europe, such as agriculture, food distribution, retail, these are all going to be very critical strategic plays in virtually all of these countries.

Bass: Yes, it's pretty much across the board. I think we see continued large investments in oil and gas as that industry changes, with private equity teaming with corporates to invest in that space. Health care and technology, as well. Technology continues to be at the forefront of private equity investment. I think when we take a look at the emerging markets, again driven by the middle class and the increased consumerism, we're going to see a lot of the deals around retail consumer products. Steve mentioned education — we continue to see a lot of transactions in that space. And then lastly, in a lot of the emerging markets, the developing economy's infrastructure. So a lot of dollars are going to be spent on infrastructure and private equity has a role there.