Private Equity: Opportunities and Challenges

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Eric L. Thunem
Managing Director
Portfolio Advisors, LLC
Alternative Investments

Hedge Funds
Infrastructure
Real Estate
Managed Futures
Natural Resources
Private Equity Funds
Timber

Leveraged Buyouts
Venture Capital
Special Situations
Distressed Debt
Mezzanine
Secondaries
Co-Investments
Other
Private Equity

• Provides capital to companies not quoted on a public stock exchange

• Multiple uses:
  • Develop new products and technologies
  • Expand working capital
  • Facilitate company growth
  • Strengthen a company’s balance sheet
  • Resolve ownership and management issues

• Domestic and International Strategies include:

  • Buyouts: Large, Middle Market, Small-Cap
  • Venture Capital: Seed/Early-stage, Late-stage, Multi-stage
  • Special Situations: Distressed Debt, Mezzanine, Multi-Strategy/Opportunistic
Where Private Equity Fits

Company Growth Cycle

- Early Stage; Development
- Entrepreneurial; High Growth
- Established; Level Growth
- Mature; Cyclic

Revenue/Profit vs. Time

- Venture Capital
- Buyouts, Sub Debt
- Special Situations
- Restructuring

Private Equity

Mostly Public
Avenues for Investing in Private Equity

- **Start your own Business**
  - Control, Management, Focus
  - Concentrated Risk

- **Invest in a Privately Held Company**
  - Influence, Shared Ownership
  - Single-Company Risk

- **Participate as a Limited Partner in a PE Fund**
  - Passive Ownership, Diversified Holdings
  - Single-Manager Risk, Limited Vintages

- **Invest in a Private Equity Fund-of-Funds**
  - Broader Diversification – Industry, Manager, Geography, Vintage
  - Diversified Risk, Fees may Lower Overall Returns
Perspectives

• **Entrepreneurs and Business Owners**
  • Active Partners, Value Add, Liquidity
  • Ownership, Control

• **Limited Partner Investors and their Advisors**
  • Returns, Diversification, Long-Term Horizon
  • Illiquidity, Perceived Risk, Lack of Information, Fees

• **General Partner Investors / Sponsors**
  • Returns, Active Strategies, Timing
  • Deal Flow, Fund-Raising, Exit Environment

• **Other Constituencies**
  • Banks, Regulators, Politicians, Media
Entrepreneurs / Business Owners

- **Private Equity Opportunities**
  - PE managers can add value to enterprises
  - Potential source of expansion financing
  - Additional expertise in specific industries
  - Governance and corporate best practices
  - Liquidity for generational transfer

- **Private Equity Challenges**
  - Ownership changes
  - Control may shift
  - Leverage can become a growth driver
New Companies/Small Businesses

Two years: 7 out of 10
Five years: 5 out of 10
Ten years: one third
15 years: one quarter

Survival rates for new employer firms
(U.S. Department of Commerce statistics, March 2010)

* Headd, B. Redefining Business Success: Distinguishing Between Closure and Failure, 2002
# Shane, S. Startup Failure Rates – The Real Numbers, 2008

Source: smallbusinessplanned.com
New Companies/Small Businesses

Source: State of Washington, Department of Revenue, excise tax data 2002 through 2005
Global Buyout Annual Investments

Source: Thomson Reuters Venture Economics, October 27, 2011
Global Venture Capital Annual Investments

Source: Thomson Reuters Venture Economics, October 27, 2011
Limited Partners and their Advisors

• **Opportunities**
  • Perceived out-sized return potential
  • Diversification
  • Long-term appreciation is possible
  • Programs may become self-funding

• **Challenges**
  • Information is not readily available
  • Investments are illiquid
  • Risks can be concentrated
  • Measuring risk can be a challenge
  • J-Curve: returns may be negative in early years
  • Minimum investment levels may be high; access is limited
Basic Mechanics: Hypothetical Cash Flow

- $1 million commitment
Basic Mechanics: Hypothetical Net Invested

- $1 million commitment

![Cumulative Return Chart]

- 65% to 80% Net Invested
Private Equity Performance: Time Horizons

Private Equity Performance: Stages

![Chart showing IRRs for different stages and types of private equity investments.]

Private Equity Performance: Vintage Years

Importance of Manager Selection

10 Year Returns: Upper Quartile vs. Lower Quartile Managers

- Private Equity: 19.5%
- Large Cap Equity: 9.7%
- International Equity: 9.4%
- Core Fixed Income: 2.9%

Source: Clearbrook Perspectives, 2010 (eVestment Alliance and Cambridge Associates)
Performance Persistence

2011 Preqin Private Equity Fund of Funds Review
Private Equity Investment Options

Investing through fund-of-funds can provide greater diversification

**Direct Investment**
- # of Portfolio Companies (PC): 1
- Single company, highest risk

**A Private Equity Fund**
- # of PCs: 15 to 20
- “Single manager” risk

**Fund of Funds**
- # of PCs: 250 to 400
- Lowest risk

**Investor**
Global Fund-of-Funds Annual Fundraising

Source: Preqin, November 8, 2011
General Partners / Sponsors

• **Opportunities**
  - Recurring management fees are possible
  - Long-term significant capital gains are possible
  - Investment strategies may involve active roles
  - Historically lower level of public scrutiny
  - Managers may have some control over exit timing

• **Challenges**
  - Regulatory oversight is increasing
  - Deal flow may not be truly proprietary
  - Traditional exit routes may exhibit volatility
  - Big payday may happen only after LPs get returns
  - Fund-raising
  - Competition
Global Buyout Annual Fundraising

Source: Thomson Reuters Venture Economics, October 27, 2011
Global Venture Capital Annual Fundraising

Source: Thomson Reuters Venture Economics, October 27, 2011
Other Impacts/Influences on LPs and GPs

- Overall economic climate
- Public equity markets
- Banks and other debt providers
- Federal and state regulators
- Media outlets; broad and industry-specific
- Politics
- Perceptions
Regulatory Environment

- SEC, CFTC, FSA
- FASB ASC 820 (formerly known as FAS 157)
- Dodd-Frank Act
  - Registration if assets >$150 million
  - Extraterritoriality (non-US firms marketing in US)
- Volcker Rule
  - No more private equity for banks (?)
- Alternative Investment Fund Managers Directive
  - European Securities and Markets Authority
  - US firms with EU investments (?)
- IRS – carried interest no longer treated as capital gains (?)
- Private Company Flexibility and Growth Act (proposed)
- FINRA rules – ban on “spinning” hot IPO shares
- Second Market scrutiny by SEC and FINRA
- Pay-to-Play rules restricting intermediaries in fund-raising
Ohio Retirement System Raises Concerns to Permira About Hugo Boss Plans to Close Cleveland Plant

Sen. Sherrod Brown letter to Permira describes "grave concerns"

CLEVELAND, March 2 /PRNewswire-USNewswire/ - The Ohio Public Employes Retirement System (OPERS) has notified Hugo Boss' parent firm Permira Advisors that the retirement system "now has concerns about future involvement" with Permira. In total, OPERS has invested Euro 110 million in Permira, an amount equivalent to about $149 million today. In 2006, OPERS invested Euro 60 million, or $81 million, in Permira IV, the name of the particular investment fund that includes Germany-based Hugo Boss.

Workers, as well as public and labor officials, contend that Hugo Boss did not bargain in good faith in trying to keep the plant open. Nearly 400 jobs are at stake; the Brooklyn, Ohio, plant is supposed to close in April.

OPERS is now demanding that the company re-engage public officials, who have already offered financial incentives to keep the suit-making factory in business.

Workers United, the union representing the plant's workers, is approaching other public employee retirement systems - including funds in Pennsylvania, Massachusetts, New Hampshire, Texas and California - and is urging them to re-evaluate investments in Permira.

On February 25, OPERS Chairman Ken Thomas and CEO Chris DeRose wrote to Permira and demanded a response by March 11. The letter reads, in part:
THE NEW YORKER

PROFILES

THE BIRTHDAY PARTY

How Stephen Schwarzman became private equity’s designated villain.

BY JAMES B. STEWART

FEBRUARY 11, 2008

On June 18, 2007, Stephen A. Schwarzman, the chairman and chief executive of the Blackstone Group, and his driver approached the Fifth Avenue entrance of the New York Public Library. Schwarzman, a member of the library’s board, was being honored that night. To his dismay, television reporters and cameramen were milling on the steps and the sidewalk. He evaded them by using a side entrance. A TV cameraman managed to penetrate the cocktail party that preceded the ceremony, and Schwarzman was startled when the glare of a camera-mounted spotlight hit him in the face.

In the previous few weeks, he had become the designated villain of an era on Wall Street—an era of rapacious capitalists and heedless self-indulgence that had driven the Dow Jones Industrial Average to new highs, along with the prices of luxury real estate and contemporary art, while the incomes of ordinary Americans stagnated or fell. Blackstone, the partnership that Schwarzman founded, in 1985, with Peter G. Peterson, Secretary of Commerce under Richard Nixon and a former chairman and C.E.O. of Lehman Brothers, was a new type of financial institution: a manager of so-called alternative assets, such as private-equity, real-estate, and hedge funds—esoteric vehicles that barely existed when Blackstone began but now accounted for trillions in assets. Most of the investments came from corporate and public pension funds, endowments of universities and other nonprofit institutions, insurance companies, and rich people. Blackstone was the world’s largest manager of these alternative assets, with $88 billion. Its investors included Dartmouth College, Indiana University, the

“You know what? I don’t feel like a wealthy person,” Schwarzman says. Photograph by Mary Ellen Mark.
BREAKINGVIEWS.COM.; WaMu's Lesson for Private Equity

by BREAKINGVIEWS.COM
Published: September 29, 2008

The new era of private equity is proving treacherous for some old hands. The collapse of the nation's largest savings and loan, Washington Mutual, highlights the point. The lender's demise handed TPG, one of the buyout world's kingpins, the kind of crushing body blow that has laid similar firms low in the past.

The bursting of the credit bubble brought an end to the easy money that allowed TPG to take big public companies private, including Harrah's Entertainment, MGM and Neiman Marcus. This drought led many buyout firms to pursue smaller stakes, not financed by debt, in public companies, where they hoped to negotiate terms and conditions that would give them an investment edge.

Among the biggest of these deals was TPG's injection of $2 billion into WaMu in April. TPG, led by David Bonderman, dove in with a flotilla of other top WaMu shareholders to collectively invest $7 billion in the struggling thrift. In return for precious capital, TPG received an array of advantages over WaMu's other common shareholders that made it a sweetheart deal.
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