TIGFI 34th Luxembourg Monthly Finance Lunch on 02 April 2014

Speaker: Richard Pelly, Outgoing CEO of the European Investment Fund

Richard Pelly: Speech for TIGFI lunch 2nd April 2014

Good Morning everybody,

I am very happy to have the occasion to speak to you in the days running up to my departure from Luxembourg. I think this is why David proposed to give me a wide ranging topic to share with you. Everybody in this room will have an opinion on Private Equity and it remains a subject of some controversy. So I thought I would address it in three ways.

Firstly, it's always worth looking back to understand the origins of myths and realities. I will then highlight a few of the most common Myths and try to put some realistic, factual context to them. I hope you will also indulge me if I finish by highlighting the role of public finance and in particular the EIF in the venture and growth capital end of the private equity market. Here again there are certain myths and realities. I would like to hear your views as well so I will leave time for questions.

The official definition of Private Equity is equity capital or shares in enterprises that are not quoted on a public exchange. However I prefer to narrow this down also to exclude equity still owned and retained by founders and family in private companies, which still form the bedrock of most economies.

In any event, the definition is wide and you could conclude that Venture Capital, Buy-outs and the role of non-quoted equity is as old as capitalism itself. I will talk briefly later about the evolution of the large Private Equity firms into a modern version of multinational Merchant banks. Well of course the origins of JP Morgan, Warburg and Rothschild was never far away from private capital.

However, the modern phenomenon of the Private equity firm or most often Limited Liability Partnership can be traced back to just after second World war and in response to the opening up of markets, the exponential development of technology and the growth of Institutional Investment.

In fact, although venture (or what was known for a long time as Development Capital) is very much the little brother of Buy-Outs, it was the opportunity to invest in high risk technology development that really drove the industry in the 50s and 60s.

Famously, Digital Equipment Corporation was the first Tech Company to be owned by Private equity and Fairchild Semiconductor was apparently the first start up. This is anecdotal but reflects well what we have seen later in the role of venture capital to take the technology and market risks and to play a critical role in economic development.

We have not got time to trace the history of Private equity over the last 40 years and many of you have lived through it like me. However, I would like to draw a few conclusions which will frame the mythology that is my main topic.

This has been a period of Boom and Bust and I would contend that the nature of the risks and rewards associated with the Private Equity model make it subject to more extreme cyclicality or volatility than other financial markets.

The world only came out of recession in 1982, but in 7 years of boom we saw LBOs, Junk Bonds, Hostile Corporate raiders, Greenmail and the beginning of the Hedge Fund era. Debt was cheaper (still nothing like we see today) and regulation...let's say self-driven!
1989 through 1991 saw the end of this era, exemplified by the most controversial Private Equity deal in History, the hostile takeover of RJR Nabisco by KKR – and it was a controversial and rather messy affair not helped by the looming recession.

We also saw the bankruptcy of a swathe of over leveraged buy-outs.
You all know that it didn't take long for markets to bounce back and for financial innovation to re-emerge.

And by 1999, we had an extraordinary environment of low interest rates, rapid technology advancement and booming stock exchanges. This time it was the turn of the venture end of Private Equity to go mad (but this contagion ran though the corporate world. I worked for GE at time and this rigorous 100 year old industrial company, whose CEO Jack Welch was the most reputed leader in the world managed to blow over 500m in their Private Equity activity).

In fact this was a short sharp shock and not a fundamental economic downturn and so 2003 saw the fund raising of all forms of Private equity firms and most spectacularly, the Buy-out market, rising again to a crescendo in 2007. However, the shakeout did have the positive effect of reducing the number of private equity firms by nearly 40% over the following years and this Darwinian phenomenon is important.

There were several other key influences and evolutions going on as well. IPOs of KKR, Blackstone and later Carlyle in the US, a drive in particularly in Europe for Regulation, Tax scrutiny. All these topics themselves could take up another TIGFI lunch.

Here it is worth saying that the crisis that we have been living with since then has not, in my opinion, been as a result of the Private Equity market growth. Clearly returns have dropped significantly for all investors since then, but there have been relatively few corporate failures, even amongst the most leveraged companies and the patience of Private equity capital has been a stability factor.

Right now ladies and gentlemen, the Private equity market outside of early stage venture is in rude health. Capital is abundant, fund raising in 2013 did not reach the levels seen in 2007, but the combination of new money, dry powder and cheap debt means that we have the ingredients of another BOOM.

A few facts to bear in mind before I look at some of the Myths

There are 1800 PE/VC firms in Europe managing 3000 funds. This is still a young industry and only the UK and France are really at a mature stage. It's a market subject to the 80/20 rule as always and scale generally matters. Worldwide the number of firms is over 7000.
Again staying in Europe, two phenomenon:
- total value of investments is approx Euros 600bn compared to public Stock market capitalisations of over 7tn. So less than 10%.
- however, the number of companies owned by Private equity is about 21,000, way more than the number in public hands.

The Boom Bust is best illustrated by data on fund raising. The peak of fund raising in 2007 reached 700bn dollars worldwide and dropped to 73bn in 2009.

Venture has still not seen a return to the heady days of 2000 and never will Eur 18bn in Europe in 2000 now languishing at 3bn.

Let me turn to some Myths and Realities (mention E&Y)

Myth Number 1

PE is fundamentally asset stripping and can be compared to locusts

I mentioned the Barbarians at the gate mythology earlier and going back into the seventies, the term asset stripping was coined to describe Slate Walker. There have clearly been examples of rapid dismembering of companies, particularly conglomerates, to extract value and make a quick turn.

However, the research is very clearly showing that PE owners to a large extent focus on absolute value growth. 80% of all PE owned companies grow by acquisition and only 10%

make significant disposals. Capital employed has been shown to rise 25% in PE owned companies and empirical evidence shows that they are more innovative.

Myth Number 2

The real story is about the use of financial engineering and leverage

No doubt that the era of low real interest rates has radically changed the way in which companies have been valued and capitalised. This also now seems to be a long term, predictable phenomena and so is being built in to all markets. There have been some real extremes and it's a fact that debt is being extended and repayments prolonged to help companies survive. However, there have been some constraints on the availability of debt due the bank deleveraging and general risk considerations.

What is more important in my view is the unquestionable outperformance of private versus public equity which is a factor of more than 3 times in the period 2005/2013 and made up of approximately 33% market, 33% leverage and 33% pure out performance.

Myth Number 3

PE Businesses shed jobs for profit

The actual facts do not bear this out. PE firms overall have grown employment 2% even during downturns...same as public companies.
More importantly productivity is well ahead of public companies with 7% labour and 11% capital productivity.

This is surely the essence of well-run competitive enterprise and achieved without job destruction.

Myth number 4

PE is dominating the corporate landscape with buy-outs and take privates. The industry is unbridled, unregulated and beyond public intervention

- you only have to look back over the last 30 years again to realise that public perception and the best economists and analysts have often been wrong even on these longer term observations

From an Economist and Business Strategists perspectives, at the peak of the biggest ever boom in 1989, it was a case of 'The Eclipse of the Public Corporation'. This was a paper written by Michael Jensen, professor of business administration at Harvard and in 1989.
Quote: “the widespread waste and inefficiency of the public corporation and its inability to adapt to changing circumstances have generated a wave of organisational innovation over the last 20 years - innovation driven by a rebirth of "active investors".

- a bit more recently, a mocking paper entitled "The Eclipse of Private Equity" was published by the Judge Business School in Cambridge. Guess what the date was....2008!

Comparison of role and effectiveness of Boards of Private versus Public companies

1. Tendency to risk avoidance coupled with short termism
2. More Strategic, able to take a longer term view, bur less sensitive to the broader stakeholder environment
3.

The reality is adaptation (perhaps sometimes too slowly and sometimes under pressure from regulators or the wider public.
- regulation
- responsible investing

Myth Number 5

PE is characterised by obscene wealth being made in a short time

Let me use the KKR example again. They have made average annual returns of 27% for 30 years and returned gains of 40bn to their investors. But even they have had bad vintages and big high profile failures. There are other examples and Warren Buffett started off as a Private Equity investor in effect.

However, right across the spectrum there is a phenomenon of only the top quartile out performing and in some periods this is reduced to the decile.

Of the 3000 funds in Europe that I mentioned earlier, only a small percentage are ‘in carry’, which means that they have achieved more than a normal hurdle rate.

It’s a real capital market with winners and losers.

Finally a bit about Venture Capital and the role of the EIF

- High risk and…rare ‘home run’ rewards
- Europe vs US

- Highly cyclical (economic and technological cycles combined)
- Evident need for Public intervention
- Model of Pari Passu
- 20% market share
- 1.5bn catalysing 7bn

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