Understanding Private Equity

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Seminar

Relations Between Private Equity Funds and Industrial Change

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Facts & Figures

- **Funds raised in Europe**
- **Annual Private Equity Investments in Europe**

In € billion

- 150.0
- 112.5
- 75.0
- 37.5


- **Pension Funds** 27.1%
- **Banks** 14.4%
- **Government Agencies** 8.7%
- **Private Individuals** 8.9%
- **Corporate Investors** 8.7%
- **Other** 4.1%
- **Academic Institutions** 3.6%
- **Insurance Companies** 10.1%
- **Fund of Funds** 15.2%
- **Capital Markets** 1.2%

Source: EVCA/Thomson Financial/PricewaterhouseCoopers
The Investment (*the supply side*)

- **Venture Capital**
  - High-tech Companies
  - Economic Growth
  - Job Creation

- **Venture Capital**
  - Expansion: 16.0%
  - Start-up: 8.0%
  - Seed: 0.3%

- **Buyout**
  - Institutional buy-out
  - Leveraged buy-out
  - Public to private buy-out
  - Management buy-out
  - Management buy-in
  - Secondary buy-out/Replacement capital

**Economic Growth**

**Job Creation**
The Effects of Private Equity - Buyouts (Empirical Research)

Plants involved in LBOs and MBOs are more productive
MBOs enhance new product and market development
MBOs result in more effective use of R&D expenditure
MBOs result in more entrepreneurial activities
MBOs lead to increases in levels of employment, training, employee empowerment, and wages
Employee have more discretion over their work practices
Symbiotic relationship - Professional services industry

No decline in R&D investment
Private equity investors are long-term investors, focused on growth and restructuring
Net performance is lower than the stock market (3%)
Gross performance is higher than the stock market (3%)
Response to overregulation

Employment and wages of non-production workers declines
LBOs result in a reduction in R&D expenditure
Plants involved in MBOs are less productive
Plants involved in MBOs experience a substantial reduction in employment
Employment falls in MBIs

Adapted from Douglas Cumming, Donald S. Siegel and Mike Wright, Private equity, leveraged buyouts and governance, Journal of Corporate Finance 13 (2007)
The Reaction: Keeping “Locusts” at Bay...

- Private Equity’s seemingly ruthless actions in restructuring companies
- Cold-hearted, greedy profiteers
- Only interested in short-term profit
- Parasites that suck out whatever juice that is left in their portfolio-companies
- Private Equity Funds cut jobs at companies
Regulation? Who Needs Protection?

Limited Partnership

- **Investors-limited partners**
  - Profit distributions 80%
- **Management Fee + Carried Interest (20% profits)**
- **Management Company**
- **Private Information**

**Limited Partnership**

- **General Partner**
  - **Private Information**

**Private Information**

**Portfolio Companies**

- Expansion
- Buyout
- Start-up
- Seed
- Replacement Capital

**Capital Markets**

- Corporate Investors
- Academic Institutions
- Private Individuals
- Government Agencies
- Fund of Funds
- Banks
- Insurance Companies
- Pension Funds
The Investors (Limited Partners)

**General Partners**
- Waterfall structure, carry calculations
- Management fees
- Clawback provisions
- GP capital commitment
- Limitations of liability
- Indemnification by GP, LP
- Investment strategy, limitations and guidelines
- Fundraising period, investment period and term
- Permitted activities by GPs
- LP approval rights

**Limited Partners**
- Waterfall structure, carry calculations
- Clawback provisions
- GP conflict issues, including allocation of opportunities
- Key man provisions
- Management fees
- GP capital commitment
- Side-letters, and MFN
- Investment strategy, limitations, and guidelines
- Permitted activities of GPs
- Portfolio company fee offsets

Adapted from Center for Private Equity and Entrepreneurship, Tuck School of Business at Dartmouth
# The Portfolio Companies and the Stakeholders

## Venture Capital
- Staged Financing
- Preferred Shares
  1. Control and Governance
  2. Downside Investment Protection

## Private Equity
- Shareholders Agreement
- Share Purchase Agreement
- Subscription Agreement
  1. Corporate Governance (incl. Board Composition)
  2. Exit and Transfer of Shares (incl. Drag Along Rights and Registration Rights)

![Diagram showing relationships between investors, PE funds, and company stakeholders]
So What About the Stakeholders?

- Contracts offer almost no protection
- Reputation of the venture capital and private equity funds
- Regulatory responses could reflect emotions

- Codes of Conduct, Guidelines, Best Practices, Industry Standards
  - European Venture Capital Association (www.evca.com) - Corporate Governance Guidelines - respect for stakeholders, transparency
  - Work in tandem with the reporting guidelines, valuation guidelines, governing principles and code conduct
- Walker Final Guidelines for Disclosure and Transparency in Private Equity (www.walkerworkinggroup.com)
  - Private Equity Firms that own or control “large UK companies”
  - Portfolio Companies - publication of annual report and accounts on the company’s website + data to BVCA
  - Private Equity Firms - (1) publish annual review of the website, (2) establish guidelines for reporting to LPs and the valuation of the investment, (3) provide data to the BVCA, and (4) communicate promptly and effectively with employees
The Enforcement of the Guidelines

• Not Legally Binding, but

• Self-regulatory

• “Sword of Damocles” in the event of non-compliance

• Non-compliance could lead to the removal or expulsion of a member
There is One More Thing... Hedge Funds

Hedge Funds vs. Private Equity

<table>
<thead>
<tr>
<th>Feature</th>
<th>Hedge Fund</th>
<th>Private Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term</td>
<td>Unlimited</td>
<td>Usually 10 to 12 years</td>
</tr>
<tr>
<td>Type of Investment</td>
<td>Fairly liquid</td>
<td>Illiquid</td>
</tr>
<tr>
<td>Investors' liquidity</td>
<td>Open-ended fund, with periodic withdrawals possible</td>
<td>Closed-end funds. Distributions at the discretion of the GP</td>
</tr>
<tr>
<td>Capital contributions</td>
<td>100% contribution at subscription date</td>
<td>Based on capital commitment drawdown over time</td>
</tr>
<tr>
<td>Management fees</td>
<td>Based on net asset value</td>
<td>Based on capital commitments</td>
</tr>
<tr>
<td>Performance-based compensation</td>
<td>Incentive fee taken yearly on realized and unrealized gains, no “drawback”</td>
<td>Carried interest on realized investments, subject to “drawback”</td>
</tr>
</tbody>
</table>
Two Views on Hedge Funds

(1) Hedge Funds could solve the corporate governance problem - they represent the shareholders as a group

(2) Hedge funds have diverging interest - short termism and empty voting
Value Creation or Destruction?

- Brav, Jiang, Partnoy & Thomas (2006) find no empirical support for the assertion that hedge fund activism destroy value or is short-term in focus

- Bratton (2006) concludes that hedge fund activism is a more benign phenomenon than its critics would have us believe

- Becht, Franks, Mayer & Rossi (2006) provide evidence of gains to shareholder activism

- Klein & Zur (2006) suggest that hedge fund managers achieve their goals by posing a credible threat of engaging the target company in a costly proxy solicitation contest
The Possible Answer: Code of Conduct

- Hedge Fund Working Group (www.hfwg.co.uk) - Consultation Paper:
  - Compy-or-Explain
  - Increased Transparency on the funds’ websites: (1) disclosure of holdings of complex securities, (2) valuation methods, and (3) policies on dealing with conflicts between investors and managers
  - Principles on shareholder conduct and activism: (1) Disclosure of derivative positions (see also FSA Consultation Paper 07/20) and (2) policies on voting of borrowed stock

Increased Disclosure and Transparency through Self-Regulation
“Conclusion”: The Need for Future Research

- Economic Impact Analysis of the guidelines and best practices
- Comparative research on the regulatory responses in European Member States: The United Kingdom, Germany, France and the Netherlands
- The new kids on the block: The Sovereign Investment Funds

Joseph A. McCahery & Erik P.M. Vermeulen, Understanding Private Equity and Hedge Funds (forthcoming 2008)
Thank you!

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