

New finance essay



Tonight, though, Iris had more Important things to think about than comparative climatology. Through a combination of preparation, experience, hard work, and, she admitted, sheer luck, the 27-year; old Native American had received three Job offers.

All were from buyout firms-? one a top-tier mega-fund, another a mid-market operation, and the last a firm looking to turn around its portfolio. Each option was attractive; each had its own drawbacks and advantages with respect to furthering Iris’s goal of a career In private equity. She would have to let them know by tomorrow at 8 a. Opportunities in the Private Equity Industry in 2009-2010¹ During her MBA studies, Iris witnessed the crash of the previously booming private equity industry.

While private equity was notoriously cyclical, this latest slump had been exacerbated by the macroeconomic credit crunch and global economic contraction. The U. S. Private equity Industry had been little more than a cottage Industry until the late asses. Although the first funds were established In the asses, the Industry largely relied upon investment capital provided by individual investors for its first few decades.

Pension funds had been reluctant to invest much of their substantial pools of capital in private equity, due both to their lack of familiarity with the asset class and to uncertainty about whether private equity conformed to federal standards. The U. S. Department of Labor addressed the latter concern In 1979 by clarifying the “ prudent man rule,” unleashing a wave of capital Into private equity funds that continued almost unabated for 30 years.

With only a few exceptions, each year saw more money invested in private equity, typically in limited partnerships that had a contractually specified 10-year life.

The investors served as limited partners (Lips)-? so named because their liability was limited to the amount they invested-? while the private equity groups served as general partners (Gaps). (See Exhibit 1 for commitments to private equity funds.) Historically, the mixture of commitments to venture capital (PVC) commitments to PVC funds in the late asses Professors Josh Learner and Field Harmony and Teaching Fellow Ann Lemon prepared the original version of this case, “ Iris Running Crane: March 2011,” HOBBS No. 809-071. This version was prepared by Professors Matthew Rhodes-Crop and Josh Learner and Teaching Fellow Ann Lemon.

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810-073 and 2000 could be attributed to the success of this asset class in the mid- to late-80s (see Exhibit 2 for annual returns from PVC and LOBO investments). While LOBO returns had outpaced those to venture capital during the 80s, the pattern reversed itself in the '90s, only to change again in 2000 and in 2007. Starting in the early 80s, LOBO firms had enjoyed ready access to low-priced debt and had generated average returns of 15. % between 2003 and 2006, compared to 9. 9% for the Standard & Poor's index and single digits for PVC.

Accordingly, LPs flocked to invest in Lobos, which raised \$344 billion in 2008, while PVC funds raised only \$63 billion. 4 Records fell for largest LOBO deal (the acquisition of Texas utility TUX by Texas Pacific Group, Goldberg Kraals Roberts, and Goldman Sacs for \$45 billion)⁵ and largest fund raised (Blackstone \$21 billion Corporate Private Equity Fund V). In fact, the co-founder of the Carlyle Group lamented, “ We should have done every single deal everywhere in the world [in 2005 and 2006].

Every deal worked. “ 6 PVC firms, which had spent the first few years of the 80s recovering from the telecoms and Internet bubbles, had little to crow about despite such high-profile successes as Google's 2004 initial public offering (IPO).

Fundraising recovered from the 80s's nadir of \$12 billion, but comparisons to the anomalous activity of 1999 and 2000 made for a sobering return to reality. Figures for LOBO activity in 2008 indicated the peak of a cycle, and the bust followed shortly thereafter, as the global financial crisis shut off the supply of cheap debt for LOBO deals.

Such loans that were available came with higher interest rates and greater bank control. Firms had to contribute more of their own money to deals, thereby reducing returns.

By the end of 2008, LOBO firms were closing offices, cutting staff, and offering to reduce LAP commitments in recognition of vastly reduced opportunities to find and consummate deals. LPS were constrained overweight in private equity. A Secondary funds, which specialized in purchasing holdings from distressed LPS, and distressed debt funds found their services in great demand.

While PVC firms were less reliant on the debt markets, the general economic slowdown affected their portfolio companies, whether through more costly financing options or smaller orders from cash-constrained customers.

Holding periods increased due to fewer exit opportunities through mergers and acquisitions or IPOs. Many experts anticipated that those PVC firms that had survived on a few bubble-era successes would finally cease operations.

For all private equity firms, reduced liquidity among LPS and their over-allocation to private equity made fundraising more difficult.

A number of buyout firms reduced their targeted fund sizes, among them TAP, which cut its financial sector investment fund to \$2.5 billion from \$6 billion; 9 Pain Capital, which cut a contentment fund by half, to \$900 million; 10 and Blackstone, which was rumored to have cut Fund VI from TTS announced target of \$20 billion. In the third quarter of 2009, 66 buyout funds closed on a total of \$21 billion, an increase in number from the prior

quarter but a drop in capital. For the entire year to date, 216 funds had closed on \$88.

5 billion, a dramatic drop from the same period in the prior year, when 394 funds had raised \$298 billion. 2 PVC firms also faced challenges. Some, including Battery Ventures, Highland Capital, and Draper Fisher Sorenson, had reduced or changed their fee structures. 13 While some firms, like Gridlock, still closed funds in weeks, the average time for a firm to raise a fund had climbed to 15 months from less a Many Lips pursue a target allocation across various asset classes.

Because public equities respond to market changes more quickly than do private equities, which are usually revalued on a quarterly basis, market downturns can leave Lips with portfolios that have excessive exposure to private equities. Than 12. 14 In the third quarter of 2009, only 17 PVC funds closed, raising \$1. 6 billion, the smallest number of funds since the same quarter in 1994 and the lowest dollar amount since the first quarter of 2003. For the year to date, 87 PVC funds had closed n \$28. 6 billion.

1 5 One reporter observed, “ Raising a venture fund is never easy, but... It’s become tantamount to trying to ice-skate uphill.

“ 16 Any firm that could raise money in this climate was truly top-tier. Yet even with reduced commitments, the total private equity overhang (unallocated but committed funds) was estimated at \$400 billion. 7 Across the spectrum of private equity, firms were focused on helping With the difficulties in fundraising, investment activity also fell. Both PVC and LOBO investments looked likely to finish the year at levels close to half of 2008 in

terms of numbers of deals. In terms of dollars per deal, venture capital investments rose in response to a number of high-valued clearance deals.

18 For buyouts, average deal values fell to \$40 million, not even 33% of sass's historic high of \$130 million. 19 (See Exhibit 3 for investment data.)

In terms of exits, the picture was mixed.

For Ipso, 2009 appeared to be outperforming 2008, with 11 private equity-backed companies listing in the first three quarters compared to 12 for all of 2008. Both of those years included at least one quarter with no venture-backed Ipso at all, for the first time since 1978. For mergers and acquisitions, 2009 had a lower number of total deals (238 for the first three quarters as opposed to 504 for all of 2008) but a higher disclosed value, due largely to the PIP of AWAY Systems.

The \$380 million that AWAY raised made it the largest PVC-backed PIP since March 2007.

Inside the Private Equity Firm Private equity groups were traditionally very lean organizations. Supposedly, this imparted at least two advantages. First, the small size allowed significant flexibility and quick responses to investment opportunities.

Second, the performance of each partner and associate could be directly observed and attributed, with compensation ND promotions allocated accordingly. After steady growth until 2006, the number of existing PVC firms (those that had raised a venture fund in the prior eight years) had fallen abruptly to 882 in 2008.

The average number of investment professionals per firm had peaked in 2001 and fell steadily, reaching 8.5 in 2008. This appeared to reflect the more challenging PVC environment (see Exhibit 4 for trends in venture capital employment growth).

Meanwhile, hiring by LOBO firms increased steadily even into 2008, buoyed by the need for additional employees to help manage larger funds ND by the diversification of many firms into different asset classes. 20 In 2009, however, employment had slowed, with firms hiring only individuals with specialized skills. 1 Salary freezes and even layoffs were said to have occurred or be planned at almost half of the existing private equity firms. 22 Compensation in the private equity industry was designed to align the interests of the Lips and Gaps. Investment professionals in private equity funds typically received compensation from two sources.

The annual salary was funded by the management fee, which in most cases was 2% of committed capital. The second component, the share of capital gains called “carried interest” or “carry,” came after invested capital had been returned to the Lips, and it reflected the partners’ share of the gains harvested in that year.

Typically, the gain was divided 80%/20% between Lips and Gaps, b “Private equity” is a term that suffers from multiple applications. Most precisely, it refers to private, as opposed to public, equity and the firms that invest in those private equities.

Recently, however, the term has been appropriated by the leveraged buyout industry and applied to large private deals that use debt. For the purposes of <https://assignbuster.com/new-finance-essay/>

this case, “ private equity’ is applied to the 3 and the partnership’s total 20% was then split among the members of the firm. Carried interest received in a given year might vary dramatically based on market conditions.

LOBO firms had additional fee streams as well.

Acquired companies often paid transaction fees, followed by monitoring fees to compensate their LOBO owners for oversight services. These might be offset to some extent against management fees paid by Lips, but they increased the fee pool available. During the asses, compensation patterns changed subtly, as affiliated groups (such as corporate PVC apartments) added some sort of carried interest to a salary and bonus scheme, and private partnerships added bonuses to the salary and carry package.

Investors in affiliated groups typically invested funds from a corporate parent rather than raising a standard fund, but without carry, talented employees tended to leave for more lucrative pay packages in private partnerships. The pseudo-carry schemes could be “ shadow’ carry or “ real” carry generated by side funds raised from outside investors (see Exhibit 5 for survey estimates of compensation levels).

Compensation packages eight also include co-investment rights, through which employees could invest in deals. Sometimes this right was unrestricted, allowing the Gaps to pick and choose among transactions (also called “ cherry picking”).

In other firms, the Gaps were required to invest an equal percentage in each transaction to address Lips’ concerns about potential incentive and conflict-

offensives problems. Lips often worried that large investments by the Gaps would reduce their own stakes in the most attractive opportunities and that Gaps might spend disproportionate amounts of time on those companies in which they had personally invested. Both 2007 and 2008 had seen substantial increases in private equity compensation, especially in the LOBO mega- funds.

The levels in 2007 were buoyed by transaction fees and carried interest from exited deals, while continued fee streams from large funds raised prior to the credit crunch sustained compensation in 2008. In 2009, according to the Private Equity Analyst/R. Michael Holt Compensation Study, median compensation overall was flat, but showed an interesting pattern beneath the surface: while partner-level salaries were unchanged from 2008 and the total compensation package (salary, bonus, and in-semination) had fallen by 12%, compensation for Junior staff had risen, with salaries up 6% and the total package up 11.2%.³ Moreover, carried interest was being shared farther down the organization, with 95% of senior associates sharing in it.

The actual amount of carried interest that would be available, however, was a much more fundamental question. For those firms that had acquired their portfolio at excessive valuations, the possibility of achieving any gains at all seemed remote. Some observers believed that the 2000 vintage PVC funds and the 2005-2007 vintage interest-? at risk. Meet Iris Running Crane

Growing up on the Blackest reservation, Iris had never thought she would become involved in private equity or go to Harvard Business School.

She had graduated top in her class with a degree in economics and finance from the University of Montana in Missoula, working summers as a liaison between the Isaiah Corporation, the Blackfoot tribe's business operation, and Zest, the corporation that developed the reservation's wind power generation facilities.

"The only good thing we've got a lot of here," Iris's grandmother used to say, "is wind." Iris's mentor at Zest had introduced her to a friend at HP Energy Financial Services in Stamford, Connecticut, a group with \$19 billion in total assets, and a division that specialized in financing clearance projects.

That division recruited her to the East Coast. "A lot of the incentives for clearance are tax credits," Iris explained, "and if you're a start-up in clearance, you don't have any profits to offset them." She started with the financial structuring group, but after two years assumed operational roles. "I helped companies arrange and negotiate debt packages and I've also done business development and partnership work," she said.

"When you're in a small company, you just roll up your sleeves and do what needs to be done. After four years and three promotions, a company record, the vice president had told her, she'd been an incredible performer, but you're going to be stalled out soon because you're so young. Think about an MBA." Despite misgivings about the usefulness of an MBA and the opportunity cost of leaving the hot private equity space at the time, Iris applied to Harvard Business School and was accepted. At HBS, Iris earned first-year honors and a number of other awards, particularly in finance. She

spent her summer internship in the business restructuring group at consulting firm CB & Co.

But decided to pursue a career in private equity. “ Experience in consulting was very useful,” she said. “ I knew I’d be hiring consultants at some point, and it was helpful to know how they look at the world. ” Iris’s long-term goal was to create sustainable Jobs on the reservation.

She said, “ I know I sound idealistic, but I grew up in such hopelessness out on the Raze [reservation]. It’s starting to turn around, but slowly. Private equity makes a difference-? it empowers people to change their reality; to take measured risks. ” The Search

Iris had known that finding a private equity Job would be challenging, despite her experience in clearance, deal structuring, and operations. She remarked: slept all fall.

I wanted to be in a real private equity firm, not a corporate operation or a limited partner. I didn’t see much future for the mega-funds in the short term unless they had a significant franchise. Beyond that, I could see opportunities in later-stage venture capital, growth equity, or mid-market buyouts if they have a niche. My experience in deal structuring makes me more attractive to buyout operations, but my work in operations could be helpful to larger Vs..

I knew I didn’t have the background for early-stage, though. Preparation Iris identified other desirable characteristics in a potential employer. She wanted to work for a firm that was well-established and had good results, ensuring

that it would not struggle to raise its next fund. In fact, she wanted to be sure that it would not have to raise money during the next few years, allowing the economy to recover more substantially.

She also looked for smart, creative investors doing innovative transactions, from which she could learn, and a compatible firm culture.

She said, “ When you’re restructuring a deal, things can get tense. You need to enjoy your colleagues because you’ll be spending a lot of time with them. ” Iris researched her list of firms intensively.

She explained, “ I wanted to know what they worried about and how I could make their lives easier. I liked the grittiness of The Daily Deal, and Pub. Com could be pretty blunt too. ” She also referenced Capitally to identify any HOBBS alumni at her chosen firms.

She tracked the undergraduate institutions of partners in each firm to see if these might turn up a link. Websites are pretty generic,” she said, “ but you can get a sense of how the firms and the partners present themselves. To determine each firm’s culture, Iris used her network. A former 5 coworker from HP had joined a private equity firm that she was not targeting, but he gave her useful insights into the culture at some different organizations. Iris also compiled 15 pages of questions that she expected to be asked during interviews, with bullets for the points she wanted to make in response.

“ I read that list ragged,” she said. “ It was great for organizing my thoughts on how I wanted to sell myself. The Options Iris’s hard work paid off with “ a wonderful early Christmas present” of three offers. Sunspots Investment

Group was a big-name, classic private equity firm that invested across the alternative assets spectrum.

Red Horse Partners was a mid-market buyout firm that focused on transactions in Texas and the southern United States. The last was Lupus Capital, which invested in later-stage venture capital, growth equity, and interested in whether the firms had sold part of the management company and when they planned to raise another fund.

She knew that firms often used a new fund to reevaluate staffing, creating opportunities for employees to advance to new positions r responsibilities. Sunspots Investment Group New York City-based Sunspots Investment Group was one of the most respected buyout groups in the world. Founded in the mid-80s, it offered a host of alternative asset investments in such areas as private equity, real estate, and corporate debt, in addition to advisory services. Sunspots had more than \$70 billion under management.

The firm claimed that it had never failed to return capital, but its 2006 vintage fund might not live up to this claim; almost completely invested, it currently lagged the median benchmark and had achieved only a 0. X multiple. Part of the firm's attractiveness to Iris lay in its counter-cyclical offerings. The restructuring advisory service, an extension of the firm's financial expertise, assisted companies with corporate finance issues, such as rationalizations or complex restructurings. Should a client appear to warrant acquisition by a financial buyer, the Sunspots advisor might introduce it to a Sunspots partner.

Although such relationships could create conflicts of interest, the firm promised to maintain clear ethical guidelines to ensure that companies received the best possible advice.

This roof appeared to be very interested in Iris's deal structuring experience. Sunspots had 500 employees, 250 of which were investment professionals, in eight offices worldwide. Teams on the buyout side, with 25% of the investment professional staff, tended to be very large, a fact that worried Iris somewhat. "How much will I learn if I'm part of a 30-person deal team?" she wondered.

Iris had some other concerns about Sunspots.

One of these was the culture. Every firm had a unique culture, she knew, and her research had indicated that Sandstorm's was very data-driven, quite hierarchical, and very intense. In addition, Iris was not particularly interested in living in New York City. "Although many of my mentors urged me to join Sunspots, I had to be certain that everything else would be exactly right," she said. While her offer came from the private equity group, there was a clear understanding that she would spend some time with the advisory team.

L really don't want to spend all my time in c Like venture capital investments, growth equity involved the purchase of an equity share and minority ownership; unlike venture capital, the company usually was operating at or beyond cash-flow break- restructuring," she said. "It's interesting as a part of a job, but only a part. I'm really looking for a chance to do private equity from soup to nuts." She also knew that Sunspots, unlike

Red Horse Partners and Lupus, had sold roughly 10% of its management company to an outside investor.

While this would not affect the firm's governance, it meant that the minority owner received 10% of the firm's gains, reducing the amount to share among the employees. Sunspots had been honest with her about the impact of the current climate on her prospects.

Iris reflected: They said that even though the markets are strengthening, the deal stream will recover slowly. The current workload is lighter, true. But much of the work involves improving operations in the current portfolio. I can certainly help out there and maybe even stand out from the rest of the associates.

There won't be nearly the sort of carry checks that there had been, but it is a chance to get into private equity. And a firm like this-? a brand-name player with a long history-? might be a great way to get credentialed.

After all, I don't see an intensively job in a top firm like this every day. Red Horse Partners Red Horse Partners was a middle-market LOBO group, founded in the late asses by a strong operations executive and two individuals from Sunspots. It had closed its third fund at \$700 million in late 2008, giving it \$1. Billion in total assets under management and demonstrating the Lips' faith in its prospects. Iris wondered whether trying to deploy the new fund would affect the partnership's strategy of moderate-sized, carefully executed deals.

Red Horse focused on buyouts of companies in the lower end of the middle market, valued between \$50 million and \$250 million, with demonstrable cash flow and good management and a particular emphasis on Texas and the Southwest, a region surprisingly undeserved by LOBO firms.

With headquarters in Austin, the partnership was small, with the four partners, a SCOFF, one other associate, and three analysts. Iris liked them all. The partners at Red Horse were less concerned about the market's weakness than were those at Sunspots. They told Iris, " We've never used a ton of debt. We'll keep doing what we've been doing.

You've been on the ground with these clearance firms and you've helped others with structuring and operations; we think you can really create a nice practice for us in clearance. Besides, all LOBO deals in our price range are local.

Everyone has money; the question is whether you went to school with their cousin or played football against their daddy. " Iris knew that her clearance background made her attractive to the group, given the dynamics of that industry and its penetration in the Southwest.

Her experience in finance, debt negotiations, and operations was another positive. Finally, coming from the University of Montana, where the Grizzlies were a perennial college sports powerhouse, offered regional credibility. But she worried that the current economic tuition would get her off to a slow start.

The other associate had been open about the work he was doing, which did not include a lot of deal negotiation or closings.

Her responsibilities would include internal consulting to the portfolio companies to help where coverage ratios were tight, and studying the current market to develop a view on future trends. There were some opportunities to acquire companies, but, as she was told, “there’s usually a hairy angle to them or why would anyone sell?” In six to 12 months, though, the firm was expecting a flood of opportunities as the market hewed, and the partners would expect Iris to create a clearance practice. Lupus Capital, with the tagline “Leaps Above the Rest,” was founded in the early 2000s by the legendary investor Wily K. Toole.

Reorganized in the late-2000s to expand its global focus, the firm was unusual: it spanned industries and countries, with a focus on later-stage venture capital, growth equity, and smaller buyouts. Its first fund had produced top-quartile results, but the 2000-vintage fund, which raised substantially more capital, had struggled with its international investments and just missed top return performance.

The 2004 fund showed the team to have regained its stride, but Toole’s \$10 billion Fund IV was in trouble. The team had entered clearance, paying excessively for companies in that sector and others.

Several companies were known to be close to bankruptcy and others staggered under heavy debt burdens. In the current environment, Lupus was looking to reposition itself as a global turnaround expert. “We know that there are a bunch of sweet little companies that are taking on water,” Toole

told Iris. “ We’ll position ourselves as a preferred buyer, turn them round, and make everyone happy.

We’d be in a great place when we raised our next fund-? we’d look like heroes to the Lips, other Gaps, and the Coos. The problem,” he admitted, “ is that we have to straighten out our own portfolio first. ” That would be Iris’s Job. She would be the restructuring specialist, working closely with the SCOFF, the partners, the portfolio companies, and the banks. Not only would she restructure deals, but she might also take short-term operating positions at the companies as needed.

“ Once we have this mess straightened out,” Tooled said, “ you’ll be a partner ND have connections throughout the industry.