

The Role of Private Equity during Global Crises

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Abstract—The term private equity usually refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. Some researchers believe that private equity contributed to the extent of the crisis and increased the pace of its spread over the world. We do not agree with this. On the other hand, we argue that during the economic recession private equity might become an important source of funds for firms with special needs (e.g. for firms seeking buyout financing, venture capital, expansion capital or distress debt financing). However, over-regulation of private equity in both the European Union and the US can slow down this specific funding channel to the economy and deepen credit crunch during global crises.

Keyword—credit crunch, distress debt, global crisis, private equity, regulation

I. INTRODUCTION

PRIVATE equity funds are often believed to have played a significant role during this global financial turmoil. For instance, Rasmussen [13] argues that private equity contributed to the extent of the crisis and increased the pace of its spread over the world. Subsequently, in the light of serious economic problems, questions arose whether regulations of these funds were sufficient or whether the effects of the global crisis could have been smoothed, if regulation and supervision had been stricter. As a result, many ideas of reforming the regulatory framework of the overall financial system including private equity have arisen. We do not agree with this. On the other hand, we argue that during the economic recession private equity might become an important source of funds for firms with special needs. However, over-regulation of private equity in both the European Union and the US can slow down this specific funding channel to the economy and deepen credit crunch during the global crisis (for more details consequences during the global crisis see, for instance, [1], [10], [11], [15], [16], [17], [18] or [19]).

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In this paper we analyze private equity business in the light of the global crisis. We describe key trends and up-to-date development of the global private equity market and related regulatory initiatives.

The paper is structured as follows. After short introduction, we discuss basic terms related to private equity. The third part provides an overview of the worldwide private equity market and key players. In the fourth section, we provide an analysis of current private equity regulation. Finally, in the fifth section we conclude the paper and state key findings.

II. BASIC TERMS

Private equity might be defined as “a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. This also includes public companies that are delisted as part of the transaction” ([12], p.2). The term private equity encompasses several industries – buyouts (investments in more mature companies), venture capital (investment in companies that have undeveloped or developing products), expansion capital (financing for growth and expansion of a company which makes a profit), etc. Although there are important distinctions between these terms, they tend to be generally referred to as private equity [6].

Buyout is a slightly more often used form of private equity investment. As can be seen in Figure 1, buyouts accounted for 66% of total funds raised in 2008, while in 2009 they accounted for 57%.

The smaller category – venture capital – is further divided into four subcategories:

- (1) seed stage represents financing of research and development of an initial concept,
- (2) start-up stage focuses on facilitating product development and marketing,
- (3) expansion stage finances growth of a company which is already making a profit,
- (4) replacement capital represents an acquisition of existing shares in a company from another private equity investor or from other shareholders.

Private equity firms create private equity funds – large pools of private money used for investing in companies. Like hedge funds, private equity funds belong to the group of contractual savings institutions. SEC [22] defines them as unregistered private collective investment vehicles pooling money from investors to invest in equity securities. Private equity funds are legally set up usually as limited partnerships, with the private equity firm as a general partner (analogy to hedge fund managers) and the investors as limited partners. The objective of a private equity fund is to invest in the equity of different, mostly unlisted, companies and to generate profits stemming from holding

stocks of a particular company in a portfolio which is then distributed among investors of the fund. Private equity management of a portfolio company works to improve the company's performance, so that its stock price rises. The private equity fund then earns profit by exiting the company, either by an IPO of its stock or by a direct sale.

III. THE GLOBAL PRIVATE EQUITY MARKET

Over recent years, the interest in the private equity market has grown rapidly because of the fact that private equity investments have experienced constantly higher returns than other more conventional forms of investment. The growth of private equity market over recent years has taken place largely thanks to private equity funds which act as intermediaries in the market. On one side there are investors, on the other issuers of securities. TCUK [20] states that almost four-fifths of private equity investments flow through intermediaries, the rest being invested directly in the issuers. Most of the overall private equity capital comes from institutional investors.

A. Global market

At the end of 2010, assets under management of private equity firms worldwide totalled \$2.4 trillion, a value only slightly higher than in 2008 but below the 2009 high of \$2.5 trillion. Thereof funds available for investment accounted for approx. \$1 trillion or 40%. Figure 1 depicts that the growth high worth of assets under management over recent years has been mostly due to the growth of the unrealised portfolio value because of lower investment activity associated with falls in equity markets [20].

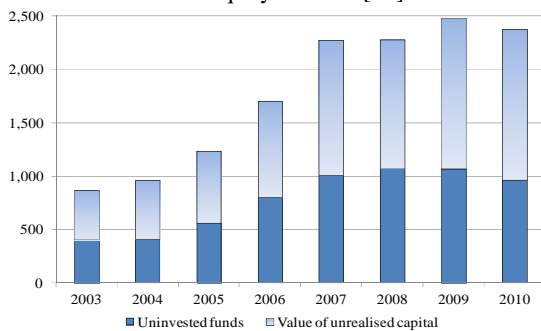


Fig. 1 Private equity assets under management worldwide (\$bn)
Source: preqin, The City UK (2011)

B. Key players

At the end of 2010, the world's largest private equity firm was Kohlberg Kravis Roberts with amount of capital raised equal to \$46.7 billion and thus comparable to the amount of assets under management of the largest hedge fund. It was followed by TPG with \$46.5 billion and Blackstone Group with \$41.7 billion. All of the ten major private equity firms listed in are based in New York and London (Table I).

TABLE I
LARGEST PRIVATE EQUITY FIRMS BY TOTAL FUNDS RAISED BETWEEN 2000 AND 2010

Firm	Location	\$bn
Kohlberg Kravis Roberts	US	46.7
TPG	US	46.5
Blackstone Group	US	41.7
Carlyle Group	US	40.6
CVC Capital Partners	UK	37.0
Apollo Global Management	US	30.6
Bain Capital	US	29.1
Goldman Sachs Merchant Banking Div.	US	28.8
Apax Partners	UK	24.8
Advent International	US	21.7
Hellman & Friedman	US	20.7
Permira	UK	18.0
Providence Equity Partners	US	16.4
JC Flowers & Co	US	14.4
Silver Lake	US	14.1

Source: Preqin

The three biggest transactions in the private equity market during 2009 and the first half of 2010 were the \$3.9 billion acquisition of Talecris Biotherapeutics by Grifols SA, the \$3.1 billion acquisition of Bridas Corp. by CNOOC Ltd. and the \$3.0 billion acquisition of Interactive Data Corp. by Interactive Data SPV. Table II displays a more comprehensive list of private equity deals.

TABLE II
LARGEST PRIVATE EQUITY TRANSACTIONS DURING 2009 AND THE FIRST HALF OF 2010

Rank	Transaction	Private Equity Firm (Acquirer)	\$ billion
1	Talecris Biotherapeutics	Grifols SA	3.9
2	Bridas Corp.	CNOOC Ltd.	3.1
3	Interactive Data Corp.	Interactive Data SPV	3.0
4	Healthscope Ltd.	Healthscope Ltd. SPV	2.1
5	Michael Foods Inc.	GS Capital Partners	1.7
6	Styron Corp	Bain Capital Partners	1.6
7	Pets At Home Ltd	KKR & Co	1.5
8	DynCorp International	Cerberus Capital	1.4

Source: Reuters

Although they were the largest over recent 20 months, these transactions were still relatively small. It becomes obvious immediately when compared to the list of largest transactions generally (Table III). The differences from the pre-crisis amounts are striking. The sum of the eight largest private equity investments of 2009 and the first half of 2010 is only slightly higher than the single seventh largest private equity transaction generally. TCUK [20] reveals that the sharp decline has taken place due to buyout managers shifting funds to distressed debt, bankruptcy financing, private investments in public equity, emerging markets and financial institutions.

TABLE III
LARGEST PRIVATE EQUITY LARGEST PRIVATE EQUITY TRANSACTIONS
BETWEEN 1989 AND 2010

	Announcemen Year	Deal value (\$bn)	Inflation adjusted value (\$bn)
RJR Nabisco	1989	31.1	50.6
Energy Future Holdings	2007	44.4	47.2
Equity Office Properties	2007	38.9	40.5
Hospital Corp. of America	2006	32.7	40.2
First Data	2007	29.0	36.4
Harrah's Entertainment	2006	27.4	33.8
Alltel	2007	27.0	29.4
ClearChannel	2006	25.7	25.1
Hilton Hotels	2007	26.0	19.1
Alliance Boots	2007	24.8	17.2

Source: Business Insider

Interestingly, Table III shows that the year of 2006 was really good for the private equity industry, as six of the eight largest private equity transactions of all times took place in this year. The years 2006-2008 were by far the most successful over recent decade as for both funds raised as well as funds invested. On the other hand, the year 2009 experienced a steep decline in both values. These facts prove a high correlation of private equity deals with economic cycles.

IV. PRIVATE EQUITY REGULATION

An assessment of private equity regulation might be done in several ways. Teply [15] developed "MAC" questions in regulation theory and argues that proposed private equity regulation in both Europe and the US will be inefficient and will bring more costs than benefits.

Similarly to hedge funds, private equity funds have traditionally been exempt from financial regulation imposed on traditional investment vehicles. What distinguishes them from hedge funds, however, is that there seems to be a wider agreement on the fact that private equity funds do not represent a significant threat to the financial system. Private equity managers deal almost exclusively with sophisticated investors who are able to assess and understand all the risk stemming from the investment. This fact is very much reflected in the type and level of regulation of private equity funds [14].

There are further arguments refusing the idea about private equity funds being systemically risky which are mostly of the following nature [12]:

- private equity relies on long-term capital and invests mostly in illiquid assets, hence the funds are not subject to runs, as was the case of many other investment vehicles;

- they do not have to sell assets in times of diminishing prices in order to fund investors' redemptions, since there are usually no redemption periods;
- low, if any, leverage in comparison to other (alternative) investment vehicles;
- portfolio companies are not deeply inter-connected with other players in the financial markets, hence they are not likely to trigger a series of losses leading to systemic risk;
- private equity funds' portfolios are diversified across multiple industries, hence they are not exposed to any single sector performance risk.

The opinion of private equity funds not being systemically risky is supported also by [5] stating that "private equity funds, due to their investment strategies and a different use of leverage than hedge funds, did not contribute to the increased macro-prudential risk". Further, neither the De Larosière Report nor the Turner Review deal with private equity funds at all, on the contrary to hedge funds. This suggests a wide agreement among experts on private equity funds being not of a systemic importance.

Indeed, considering the EU, until recently there was no harmonised regulatory framework for private equity at the EU level. Instead, the industry was regulated on a national basis in most EU member states. Notwithstanding, according to EVCA, the private equity industry was indirectly affected by other EU legislature, such as the Markets in Financial Instruments Directive, UCITS, the Pension Funds Directive, and the Capital Requirements Directive in a way of placing regulatory requirements on the institutional investors investing in private equity funds [14].

Nevertheless, the main documents representing the post-crisis regulatory response of both EU and the U.S. actually do deal with private equity, mostly because the alternative investment sector of the financial market, which along private equity covers also hedge funds, etc., is usually looked at en block by the regulatory authorities. So, the AIFM Directive reshapes regulatory framework of the European AIFs, including private equity funds. And it is widely criticized for this "one-size-fits-all" approach, since, besides not distinguishing between various types of AIFs, it does not even distinguish between systemically important funds and those with no systemic potential. Hence, private equity funds are subject to the same requirements as hedge funds although they are much less controversial from the systemic point of view. Further, although the industry welcomes the fact that some kind of legal certainty has been achieved, it is concerned that some provisions of the Directive might cause an unintended harm to small businesses in the form of adversely affecting financing of SMEs [23]. The adoption of the Dodd-Frank Act in the U.S. will have broad consequences for private equity funds. According to the Act, all private equity funds with more than \$150 million of assets are subject to registration as well as periodic inspections by the SEC. If the SEC finds the fund too risky, it can place it under the Fed supervision [1].

Venture capital funds are exempted from the obligations imposed by the Act which generally is a welcomed fact, since companies benefiting from the activity of venture capital funds will not be adversely affected. The Volcker Rule, which is incorporated in the Act, limits banks in their investments in private equity funds. Generally, the Act places heavy focus on banking institutions while imposing only moderate provisions upon alternative investment vehicles. Hence it creates a competitive advantage for institutions such as private equity funds in a way that they are likely to benefit from banks being forbidden to engage in certain activities, e.g. proprietary trading.

V. CONCLUSION

The 2007-2009 global financial upheaval has taught risk management lessons that will be crucial for future financial markets development. Regulation of financial markets should help diminish the negative impact of future potential crises by adding higher credibility, accountability, transparency and risk diversification of the world financial markets [1]. Private equity funds are often believed to have played a significant role during this global financial turmoil. In the light of serious economic problems, questions arose whether regulations of these funds were sufficient or whether the effects of the global crisis could have been smoothed, if regulation and supervision had been stricter. As a result, many ideas of reforming the regulatory framework of the overall financial system including private equity have arisen. We argue that during the economic recession private equity might become an important source of funds for firms with special needs. However, over-regulation of private equity in both the European Union and the US can slow down this specific funding channel to the economy and deepen credit crunch during the global crisis.

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