Bloomberg

Buyout-Boom Shakeout Seen Leaving One in Four to Starve

By David Carey - Feb 12, 2013

Private equity, an investing trade plied by 4,500 firms with $3 trillion in assets, is bracing for a shakeout that's been brewing since the collapse of credit markets choked off a record leveraged-buyout binge.

Firms that attracted an unprecedented $702 billion from investors from 2006 to 2008 must replenish their coffers for future deals and avoid a reduction in fee income when the investment periods on those older funds run out, typically after five years. As many as 708 firms face such deadlines through 2015, according to London-based researcher Preqin Ltd.

Private-equity firms pool money from investors including pension plans and endowments with a mandate to buy companies within five to six years, then sell them and return the funds with a profit after about 10 years. The firms, which use debt to finance the deals and amplify returns, typically charge an annual management fee equal to 1.5 percent to 2 percent of committed funds and keep 20 percent of profit from investments.

While fundraising is a routine part of the buyout business, today's environment is anything but. Many firms are suffering from below-average profits on their boom-period funds and top executives from Carlyle Group LP co-founder David Rubenstein to Blackstone Group LP President Tony James say future returns will be far more modest than those investors got used to in the past. As investors gravitate to the best-performing managers and cut loose others, 10 percent to 25 percent of firms may find themselves without fresh money.

'Rather Massive'

"The shakeout will be rather massive," said Antoine Drean, chief executive officer of Triago SA, a Paris-based firm that helps private-equity firms raise money. Drean estimates that as many as a quarter of private-equity managers will see their funding pulled by 2018.

The firms are under growing pressure to invest the capital they already have. About 28 percent of the money raised from 2006 to 2008 has been paid back to investors, according to Cambridge Associates LLC, a Boston-based research and consulting firm. More than $100 billion, or 14 percent, of the $702 billion raised, is yet-to-be invested dry powder that firms must use or lose by the end of 2013, according to Triago. That's a record for dry powder set to expire in a single year, Triago said.

What's more, performance has sagged, most markedly on LBOs done at the peak. Since 2007, the industry's median return has been 6 percent a year, below the 7.5 percent that many pensions need to pay retirees and far beneath the industry's historic average of around 13 percent. Notable among the underachievers are many of the megafunds, multibillion-dollar pools raised in the boom by brand-name houses like Blackstone, TPG Capital and KKR & Co.

'Some Carnage'

Blackstone's $21.7 billion fund from 2006 had a 2 percent net annualized internal rate of return as of Dec. 31, according to a Blackstone regulatory filing. TPG's boom-era funds -- an $18.9 billion vehicle raised in 2008 and a $15.4 billion vehicle from 2006 -- were generating returns of 2.5 percent and a negative 4.9 percent annually as of June 30, according to the California Public Employees' Retirement System, a TPG investor. KKR's annual return on its $17.6 billion fund from 2006 was 6.9 percent as of Sept. 30.

That combination of underperformance and funding needs has set the stage for a purge as investors pull the plug on the weakest firms. Only the scope of a shake-out is a matter of debate.

"There will be some carnage," said Jay Fewel, a senior investment officer for the $73.5 billion Oregon state pension fund in Salem, Oregon, which has been investing in private equity for more than 30 years. "A lot of folks raised money in the mid-2000s, when it was pretty easy. Now there are probably too many funds out there."

Weeding Out

David Fann, CEO of TorreyCove Capital Partners LLC, which advises large limited partners such as the Oregon Investment Council and Teachers' Retirement System of the State of Illinois, estimates the bottom quartile of any vintage, or fundraising year, will struggle to get backers to commit to new funds. Drean at Triago says the $3 trillion in assets overseen by private-equity firms will shrink by as much as 20 percent in the next five years.

Erik Hirsch, chief investment officer at pension-fund adviser and investment manager Hamilton Lane Advisors Inc., expects a less Draconian though still sizable culling, of about one-tenth of firms. While the industry's five-year average return of 6 percent is lackluster by past standards, it still topped the Standard & Poor's stock index's 0.2 percent figure over that span.

"There will be a weeding-out process over time," Hirsch said in an interview in New York. "It's not going to happen overnight."

Forstmann Little

It wouldn't be the first time that firms see their assets diminished. In the early 2000s, the bursting of the technology- stock bubble caused two of the most formidable buyout firms of that era to crater: Hicks Muse Tate & Furst, based in Dallas, and Forstmann Little & Co., based in New York. A host of venture capital shops were wiped out from 2000 to 2002, as venture assets fell by almost 15 percent, according to Preqin.

Hicks Muse, led by Tom Hicks, a charismatic financier who owned the Texas Rangers professional baseball team, in 1999 raised a $4.1 billion fund, then second in size only to that of Henry Kravis's KKR & Co. Ted Forstmann was a buyout manager known for publicly criticizing Kravis's habit of financing deals with junk bonds, calling it reckless.

Hicks Muse

Soured wagers on telecommunications and technology torpedoed Hicks's and Forstmann's operations. Forstmann lost a combined $2.5 billion on two companies, XO Communications Inc. and McLeodUSA Inc., that were restructured in 2002, regulatory filings show. The loss erased close to half his firm's capital base, a person familiar with the matter said. Forstmann, who didn't raise another fund until his death in 2011, bought just two large platform companies after 2001 and sold most of his firm's holdings.

Kathleen Broderick, a Forstmann Little director, didn't return messages seeking comment.

Hicks Muse lost more than $1.5 billion of investors' money in about a dozen deals over three years, mostly in telecommunications. The 1999 fund dealt investors an overall loss of 32 percent, according to the Oregon state pension. Hicks raised 60 percent less money in 2001 for his next fund, and by 2005 the firm had sundered. Hicks along with top partners Charles Tate and Michael Levitt left, and the firm's London team, which had a good track record, split off. Hicks Muse soldiered on under a new name, HM Capital Partners, a shadow of its old self.

Lowered Expectations

Today, the industry's largest firms are cushioned from such risk because they have morphed into vast, diversified vendors of everything from real estate to credit and hedge funds. That's not to say they're immune from fundraising woes.

Rubenstein, co-chief executive officer of Carlyle, the second-biggest alternative-asset firm, has been preparing investors for a future of lower returns from buyouts.

"We do think that private-equity returns probably will come down compared to the historic highs we had 10 years ago," Rubenstein said in a November interview on Bloomberg Television. Carlyle, which produced average gross returns of about 30 percent a year over its 25-year history, is now targeting gains of about 20 percent, he said.

Flagship Funds

Carlyle's $13.7 billion buyout fund from 2007 posted a 10 percent net internal rate of return through Sept. 30, 2012. That surpassed the returns of other boom-era megafunds. A year ago the Washington-based firm started raising a new flagship fund with a target of $10 billion, corralling more than $5 billion through Dec. 31, according to a Carlyle investor.

New York rival KKR began seeking money almost two years ago, targeting $8 billion for its latest buyout fund, less than half the size of its $17.6 billion predecessor. KKR said this month it had raised $7.5 billion so far and would extend the fundraising into the second half of this year. Unlike previous KKR flagship funds, which invested in North American, European and Asian companies, the new fund will invest solely in North America.

David Bonderman's TPG, based in Fort Worth, Texas, is expected to seek fresh money in 2014, a person familiar with the matter said. The firm's two previous funds were dogged by blow- ups, including an investment it made with KKR in Texas utility Energy Future Holdings Corp. TPG put $1.5 billion into the company, the person said. As of Dec. 31, KKR valued its Energy Future holding at just 5 percent of what it had invested.

Energy Future

Energy Future has hired law firm Kirkland & Ellis LLP to help restructure its debt load, a person familiar with the matter said last week.

Fortress Investment Group LLC, whose 2006 main fund is valued slightly below cost, for now has tabled plans for a replacement and set its sights on specialized vehicles, according to Gordon Runte, head of investor relations for the New York-based company.

Carlyle spokesman Chris Ullman declined to comment on fundraising. Owen Blicksilver, a spokesman for TPG with Owen Blicksilver Public Relations Inc., wouldn't comment on the firm's performance.

Smaller firms that haven't diversified are facing bigger risks. J. Christopher Flowers, who raised $7 billion in 2006 to invest in financial services companies, has delivered a negative 23.3 percent annual return on a fund valued at just 0.35 times of cost as of Sept. 30, according to the Oregon state pension. The 2011 collapse of MF Global Holdings Ltd., a broker headed by his friend and former Goldman Sachs Group Inc. cohort Jon Corzine, cost Flowers and his backers almost $48 million.

Flowers's Ride

Flowers hit the jackpot shortly before starting his New York-based JC Flowers & Co. buyout shop in 2001. He scored more than a sixfold windfall on a $1.1 billion bailout he led in 2000 of Shinsei Bank Ltd., formerly Long-Term Credit Bank of Japan Ltd. Later investments in Germany's Hypo Real Estate Holding AG and German shipping lender HSH Nordbank AG, along with a follow- on bet on Shinsei, foundered.

Although the $7 billion fund's investment period ran out in mid-2012, according to a person familiar with the matter, Flowers kept in the game by closing a new, $2.3 billion fund in 2009. He raised most of that in 2008, said the person, asking not to be named because the fund is private.

The newer fund has generated about a 10 percent cumulative net return, according to a September 2012 report to investors that Bloomberg obtained. Yet his topsy-turvy ride may make it hard to win converts for future pools, according to four institutional investors, who asked not to be named. Two of them, who invested with Flowers in the past, said they would not do so again.

Bono-Backed

Jordan Robinson, JC Flowers' head of investor relations, declined to comment.

Elevation Partners is another prominent outfit struggling under subpar returns. Backed by venture capitalist Roger McNamee and pop star Bono, Elevation started in 2004 with a $1.9 billion inaugural fund. By early 2010, bad bets on smart-phone maker Palm Inc., magazine publisher Forbes Media LLC and dubbing company SDI Media Group, a provider of dubbing and subtitling services, had dropped its annual return to minus 12 percent, according to the Washington state pension fund.

Investors that year rejected its request to extend the fund's soon-to-expire investment period by a year, which would have kept in place fees on the Menlo Park, California-based firm's $500 million of dry powder, three people said.

Facebook Windfall

Then along came a windfall. Starting in late 2009 and 2010, Elevation sank $270 million into Facebook Inc. The social network site's public offering in May gave Elevation a $1.25 billion gain on paper, lifting its returns into the teens and emboldening it to prepare a $1 billion fundraising effort, according to an investor. An investment in the website Yelp! also paid off handsomely.

Since then, a decline in Facebook's share price has reduced the fund's return to an annual 8.1 percent as of Sept. 30, below the 10 percent median return for 2004 funds, according to Cambridge Associates. Elevation suspended fundraising after Facebook's shares slumped, two people said. One backer, who asked not to be named because the firm is private, said he's not planning to commit to a new fund, because investors seek consistency, not hit-and-miss results.

Paul Kranhold, a spokesman for Elevation Partners, declined to comment on fundraising.

Terra Firma

Then there's the tale of Terra Firma Capital Partners' Guy Hands, whose firm was spun out of Nomura Holdings Inc. in 2002. Two years ago, investors gave Terra Firma little chance of surviving after it had lost about 30 percent of a 5.4 billion- euro ($7.2 billion) fund it raised in 2007 on a failed, 4 billion-pound ($6.3 billion) buyout of U.K. music giant EMI Group Ltd. The loss pushed the fund's return to a negative 19 percent annually as of Sept. 30, according to the Oregon state pension fund. The fund was valued at just half of its investment cost.

EMI was the very sort of misfire -- squandering a large part of the firm's war chest on a ruinous deal or two -- that had once doomed Forstmann Little. The 2007 fund's investment period lapsed in May of last year, Terra Firma having shelved efforts to raise a follow-on fund, a person close to the firm said. Early last year, Hands dipped into his own pocket to pay his best deal makers 20 million pounds to keep them from decamping, the person said.

'Brilliant Investments'

Hands, whose firm is based in London, continued to make deals, announcing in November a 3.2 billion-pound takeover of Annington Homes Ltd., a provider of housing to the British military, from his former employer, Nomura. Hands, who had built the housing portfolio for Nomura, rustled up 500 million pounds of equity for Annington, according to a person familiar with the transaction.

Terra Firma plans to raise a 3 billion-euro fund to invest in renewable energy projects, according to the Financial Times.

Andrew Dowler, a Terra Firma spokesman at RLM Finsbury, said the firm had no comment.

Kevin Albert, global head of business development at private-equity fund-of-funds manager Pantheon Ventures LLP, said Hands has a fighting chance of rallying back.

"If Hands is able to string together a couple of one-off deals, will people fund him again? It's possible," Albert said. "He makes mistakes, but he makes brilliant investments as well. People love a turnaround story."

Unlike hedge funds, whose investors can pull money in regular intervals, forcing them to shutter after a few bad years, buyout firms die slow deaths. Some that can't raise new money eventually fade away, after subsisting for a spell as so- called zombie funds.

Zombie Funds

Sustained by management fees they earn on unsold holdings, their ranks include onetime marquee names like Brera Capital Partners LLC, Lehman Brothers Holdings Inc. spin-out Cypress Group LLC, Jay Alix's Questor Management Co. and Stonington Partners, which sprang out of Merrill Lynch. The four haven't raised money in more than a dozen years.

Officials at Brera, Cypress and Questor didn't return calls seeking comment. Stonington no longer exists. A former partner, James J. Burke, who now heads the investment firm J. Burke Capital Partners LLC, didn't respond to messages.

Charterhouse Group Inc., a middle-market buyout firm founded almost four decades ago, last year threw in the towel on its fundraising efforts after more than two years in the market without holding an initial fund close.

Cheri Lieberman, Charterhouse's chief financial officer, didn't respond to a request for comment.

Rolling Over

Others get creative. London-based Duke Street Capital, like Terra Firma, has opted to fund future buyouts deal by deal after it failed in 2011 to attract interest for what was to be its seventh fund, according to Zoe Pocock, a Duke Street spokeswoman at Pelham Bell Pottinger. Willis Stein & Partners LP and Behrman Capital LP last year struck arrangements with outside backers to buy out the stakes of investors wishing to exit their old funds, while rolling the remaining stakes into new vehicles.

Yet other firms splinter and rename themselves. Such moves don't always pan out, as Hicks Muse's recent history attests. The shop, renamed HM Capital Partners following Tom Hicks's departure, in 2008 gathered $780 million for a fund focused on food and energy deals, which had been Hicks Muse strong suits. But HM also was hurt by bad deals and early last year said it would wind down.

'Crowded Out'

Another of Tom Hicks's offspring, Lion Capital LLP, Hicks Muse's former European arm, has fared better, raising more than 1.5 billion euros so far for its third fund, a person briefed on the matter said.

Those that shut down, like Candover Partners Ltd., an old- line British firm pummeled in the financial crisis, are exceptions. And Candover, like many foundering firms, spawned an offshoot after closing down in 2010, Arle Capital Partners LLP, that took over its holdings and operations.

"They don't disappear quickly," said Albert. "The shake- out will occur, but it will take time."

Beyond sweeping out many of the industry's weakest shops, some expect that investors will drop run-of-the-mill performers, as they move to concentrate their bets on a handful of larger firms with strong records. That's partly because many pensions that have invested with 100 or 150 firms are seeking to cut back to a more manageable number with better returns.

"A lot of large investors are doing triage on their portfolios," said Kelly DePonte, a managing director at pension adviser Probitas Partners LLC in San Francisco. "They're doubling down on the firms they like, while not re-upping with other firms," he said, citing moves by the country's two biggest pensions, the California Public Employees' Retirement System and the California State Teachers' Retirement system.

"Nobody needs just another middle-market group," he said. "Unless you have a distinct advantage and strong track record, you're at risk of being crowded out."

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