by Cyril Demaria

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PE's Achilles? Ego!

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For the first time in history, the number of private equity fund managers has contracted from 4180 to 4130 in 2010, according to Preqin. It comes at a tough time—private equity has been almost uninterruptedly under public scrutiny notably in Germany ("locusts"), the UK (taxation) and the US (taxation, and presidential elections primaries). The regulatory bellwether, which acted in favor of private equity for so long, is now swinging back. The last salvo combines national regulations such as the Volcker Rule, the Dodd-Franck Act and the FATCA; European directives such as the AIFMD; regional (European Solvency II Directive) and international (Basel II & III Agreements) solvency regulations. More could come, with new solvency regulations for pension funds. The simultaneity and the scale of these events indicate that private equity is reaching adult age. Talk about growing pains!

Somehow, PE fund managers apparently have not noticed. It might be because their ego is at stake. This was the source of the sector's success: the networks and personalities of fund managers have drawn attractive investment opportunities, at that time negotiated essentially at arm's length. Early successes, hard work and strong performances have created a self-reinforcing virtuous circle where reputations attracted a solid flow of excellent investment opportunities, the know-how accumulated added value to portfolio companies, sales of portfolio companies generated high profits and fed stellar reputations.

However, the very same ego which was instrumental in this success is now private equity's biggest liability. The ego of current private equity fund managers has prevented them to deal with their successions (one of the main reason of the flock to the stock exchange of private equity fund managers has been to set a price and a market for the ownership of these structures, to handle successions). Moreover, private equity fund managers are unable to act in a concerted, clear and beneficial way for their industry. Lobbying is at its worst, based on half-baked studies and corporate Orwellian "novlang." Cosmetic philanthropy does not help to improve the image of a profession seen as greedy, careless and detrimental to society at large. Some recent declarations from preeminent private equity fund managers did not help in that respect.

The first step for private equity fund managers is to acknowledge that they were the lucky surfers of a once-in-a-history wave: they were at the right place, at the right moment. They are not geniuses, or even specifically admirable human beings. Declining stock exchange returns and willingness of institutional investors to invest in alternative assets have lead to major shifts in asset allocations. As a result, modern private equity grew from roughly $10 billion under management worldwide in 1990 to an estimate of $1.7 trillion by 2010. But we've hit a plateau.

It is time for private equity fund managers to recognize that the world has changed. Private equity's success was born from a new form of corporate governance (analyzed by Michael Jensen back in 1989). This know-how is now largely an intellectual commodity. Private equity fund managers they have to handle concessions on tax rates in the UK and the US; and adjust their incentive structures (management fees and performance fees) to the fact that private equity is no longer a niche activity but a full fledged asset class.

A major source of change is the unspoken split between large and mega LBO fund

managers (such as The Blackstone Group), which essentially just renewed merchant banks. They should be treated as such, both on a tax and regulatory level (especially in dealing with conflicts of interests). On the other hand, small and medium-size LBO, growth and venture capital, special situation investors, mezzanine debt providers which constitute standard private equity have to come back to the original values of the sector in the way they operate businesses; in their commitments towards entrepreneurs and teams; in their ethics: modesty, long term orientation, arm’s length transactions and truth to one’s word.

These values have fed the private equity funds managers’ networks (the core asset) of contacts, investment opportunities and trade buyers. To face these new conditions, private equity fund managers have to innovate again, be more nimble and risk-prone in terms of incentives. They also have to put their money behind their words: their wealth should not be put in philanthropic initiatives, but in their funds for a significant portion (if not all) of their wealth (far above a cosmetic commitment of 1% of the size of the funds their manage). If private equity fund managers became usual citizens paying usual taxes, generating social value as much as financial in that process and sharing a significant part of the risk with their investors and entrepreneurs.

Cyril is an asset manager specialized in private equity. Opinions expressed here are entirely his own.

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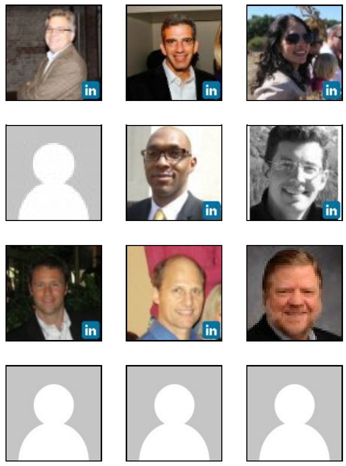

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