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Introduction to private equity

CYRIL DEMARIA

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Foreword

Private equity can be described as ‘investments in private companies in privately negotiated transactions’. This means that private equity is an asset class that is normally opaque, illiquid and difficult to analyse.

However, private equity investing offers many advantages compared to investing in public and more liquid asset classes. The underlying companies can be acquired in a private transaction, often in a specific process leading to attractive acquisition. The companies can be developed privately on the long term, hence maximizing their chances to succeed, when most public companies are only targeting short term benefits. Fund managers active in private equity normally have much more information when they make investment decisions compared to those investing in public companies. Incentives for the management can be better aligned with the investors’ interests. Fund managers exercise a higher degree of control on the companies they have invested in, and develop them aggressively without having to worry about how every decision is understood by the public. Through private equity investments, investors can target industries or niches where there are no public companies.

Private equity is a very complex asset class, more of an art than other forms of investments which are analyzed and compared quantitatively. Private equity is an asset class where manager selection plays the highest role of all asset classes. There are normally several private equity managers that are in the same state of development of their own activities. Some have decades of experience and some have worked as a team for a long time. Some have made several investments in the same industry repetitively and some of them have sold their investments at significant levels of profit. This means that analysing private equity investments and fund managers requires skill and experience.

Private equity is no longer as private as it used to be. Because of all the large leveraged buy outs during the end of 1980s and the mega leveraged buy outs during the past few years, private equity transactions have been widely reported and followed. Private equity is a long term asset class and investors will realise the final return long after they have made decision to invest. Warren Buffett stated once that it is extremely important to understand where to invest in because eventually ‘only when the tide goes out do you discover who’s been swimming naked’.

Despite all these mentioned difficulties and hurdles, Cyril Demaria has been able to write an interesting and extremely well formulated book about private equity. Cyril has seen and experienced private equity from many angles and in different roles. Cyril has been an investor directly in start-up companies and more developed and well established businesses. Cyril has

also been an advisor and investor in private equity funds. Most importantly, Cyril has been writing about the private equity industry in many papers and magazines for more than a decade. The experience Cyril has gathered from all his professional activities and his passionate interest in private equity has enabled him to write this book in an easy and understandable way but still giving the reader a very good picture of the asset class and also its pitfalls. In this book, Cyril has been able to give the topic of private equity more flavour with a lot of anecdotes and historical references which hopefully shows the reader that private equity as such is not a new invention.

I have had the honour of working together with Cyril and have read his articles and papers for many years. Cyril is a very knowledgeable person in private equity, he is critical and does not swallow all the polished information that is generally written about private equity.

This book opens the world of private equity to the reader in a very understandable way, making this opaque asset class more understandable for the reader and hopefully an interesting asset class to invest in.

Tom Eriksson
Aeris Capital

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About the Author

Cyril Demaria is a Partner at Tiaré Investment Management AG, a Zürich-based wealth and investment management company. Prior to that, he created a multi-strategy fund of funds focused on the environment. He was also an Associate in private equity funds of funds (Zürich, CH). He participated in the market development in France, and evaluated American, European and Middle Eastern private equity funds. As a Portfolio Manager responsible for private equity fund investments at a major French insurance group (Paris, FR), he managed 27 investments totalling EUR 60 million in private equity funds and funds of funds. As Head of Corporate Development at Externall (Paris, FR), he managed four asset acquisitions and raised debt financing to do so. He started his career in a hybrid venture capital and funds of funds firm (San Francisco, US; Paris, FR). He currently manages a small business angels fund (Pilot Fish I, vintage year 2009).

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- *Développement durable et finance*, Maxima, 2003;
- *Introduction au private equity*, Revue Banque Editeur, 2006, 2nd ed. 2008, 3rd ed. 2009 – foreword by Xavier Moreno (former President of the AFIC, Managing Partner of Astorg Partners);
- *Profession: business angel – Devenir un investisseur providentiel averti*, with Fournier M., Revue Banque Editeur, 2008 – foreword by Claude Bébéar (Chairman of the Board of Axa, Chairman of the think tank Institut-Montaigne);
- *Le marché, les acteurs et la performance du private equity suisse*, with Pederghana M., SECA, 2009 – foreword by Patrick Aebischer (President of the Ecole Polytechnique Fédérale de Lausanne).

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Introduction

Why another book about private equity, and especially an introductory one?

The answer lies in my experience of reading the different kinds of literature available and my recurring lack of satisfaction regarding their ability to combine so as to formulate an articulate theory. Each piece of the private equity puzzle is interesting, but they somehow do not represent an harmonious and clear picture. I am obviously not the only one to be dissatisfied: the success of the abridged French version of this book (Demaria, 2006 & 2007), of which the first edition as well as the updated reprint were sold out each within less than a year, tends to confirm it.



Cartoon I.1 The potentially disruptive impact of a French input ...

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There have been honourable attempts to paint a portrait of this emerging asset class, by famous and reputable institutions, such as The Institute of Chartered Accountants of England and Wales (ICAEW). Many academics from different disciplines as well as finance practitioners have also tried to contribute to public enlightenment. One of the criticisms made of these written works is that they remain prisoners of ill-adapted theoretical frameworks. Designed as toolboxes for analysing quantitative data, these frameworks soon reveal their limitations as they were not designed specifically to analyse this asset class. Hence, private equity cannot be turned simply into equations as is done for hedge funds. Qualitative analysis is a determining factor at every level of the private equity pyramid of financing. For that reason, using mathematical tools designed for other areas of financial or economical analyses means taking the risk of encountering the limitations of such an exercise.

The second reason lies in the discrepancies which can be observed between academic research and empirical observations by practitioners. There are constant gaps between the findings of the former and the facts as reported by the latter. This holds true for the analysis of fund performance, for the source of value creation in private equity, for the origin of the relative decline of venture capital in certain countries and many other areas. However, highly acclaimed academics, such as Josh Lerner, Antoinette Schoar and Paul Gompers, are extending our knowledge of this difficult and largely misunderstood part of a broader category of finance called ‘alternative assets’.

A MOVING TARGET

Private equity is constantly being redefined. Establishing a typology of transactions is thus especially tricky, notably when there is semantic confusion. Although being only one of the components of the private equity market, *LBO and private equity are used interchangeably in the United States*. Beyond the fact that LBOs represent the great majority of investments made in private equity (whether in the US or in Europe), it is its bad reputation which got the word ‘LBO’ blacklisted. Associated historically with asset-stripping, this reputation is now contaminating the expression ‘private equity’. Warren Buffet classified private equity managers as being ‘porn shop operators’, and the semantic confusion between private equity and LBO as ‘Orwellian’.

Because of its intrinsically changing nature, the expression ‘private equity’ covers only part of its field of action. The ‘private’ or unlisted element is no longer decisive; nor is that of ‘equity’.

One *mistake* is to state that ‘*private equity*’ is (*just*) ‘*equity*’. From this assumption, it might also be assumed that private equity may be analysed validly with the tools used for public equities. This has so far been proven *wrong*: the timeframe, the risks, the skills required and the returns associated with private equity investments differ substantially from those associated with public equities.

If not ‘equity’, then ‘private’ could appear as defining the sector and open it to the non-listed methods of analysis. Once again, this has been proven *wrong*: not only is there no proprietary private finance method of analysis which could be transposed as such, but that which defines ‘private’ assets is more their lack of listing than common factors defining them as belonging to ‘alternative assets’.

A CONSUBSTANTIAL LACK OF INFORMATION

Ill-adapted theoretical modelling and the frequent gaps between research and the facts result from a lack of information: *information is collected scarcely, heterogeneously and unsystematically*. Not only has this been the case to this day, but will remain as such for the foreseeable future.

Producing information costs the economic agents a great deal and is sometimes disproportionately expensive compared to their size and revenues. As private equity deals with small- and medium-sized companies and these account for most of their activity (the criteria being the size and number of companies being financed), it is highly unlikely that there will be a ‘pure and perfect information context’ any time soon for non-listed companies – which happen to make up 99% of the total number of companies in a given economy.

This lack of available information has resulted in some *methodological simplifications*. For example, observers assimilate casually the findings for a part of the sector, for example large buy-outs operated in listed companies, as a *general rule* for the entire activity of leveraged buy-outs. This is proven wrong regularly. Small- and medium-sized companies are bought out by different fund managers, with substantially different financing techniques and investment purposes.

Another inaccurate simplification is to assimilate the private equity sector with private equity funds. Even though these intermediaries are probably a good indication of the trends in the sector, they certainly do not sum up private equity activity. Fund managers have organised themselves in rich and powerful national (such as the British Venture Capital Association or the Association Française des Investisseurs Capital) and regional associations (e.g. the European Venture Capital Association and the National Venture Capital Association) which tend to hide the existence of other players.

For example, business angels play a significant role in the venture capital sector – even though largely yet unknown. These business angels, also called angel investors, are the very first individuals willing to support an emerging venture. Corporations, endowments, foundations, high net worth individuals, state-owned structures, banks, insurance groups and other economic players are also making direct investments which are not necessarily observed by the associations mentioned above.

BENIGN NEGLECT, MALIGN CONSEQUENCES

Those simplifications have significant *consequences*: findings are not put into perspective; action plans taken, notably to correct market imbalances, are ill-adapted; and there is a growing antagonism between the different parts of the private equity system for that reason.

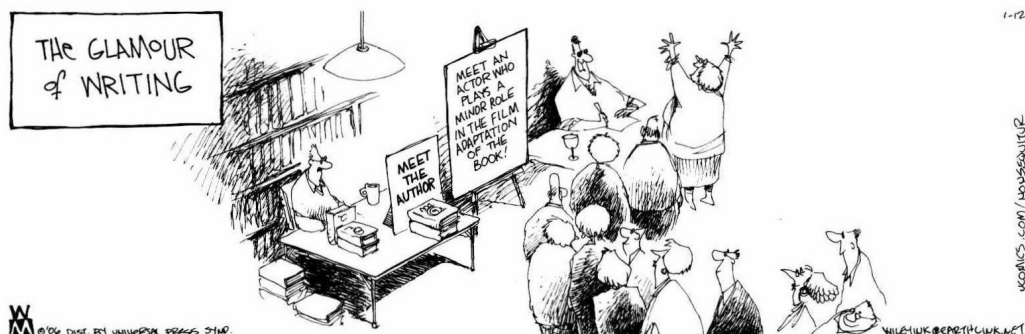
For example, the French (2007) and British (2009) governments have been focusing on start-ups at seed stage, because according to public statistics, venture capital funds have not been investing in them sufficiently. This was perceived as a market imbalance which had to be corrected. Whether true or not, this gap in financing has been targeted by a set of measures *heavily financed by the tax payer's money*.

Another example is to be found in federal venture capital funds of funds in the US and the UK (2009). Innovation America and the National Association of Seed and Venture Funds (NASVF) suggested the set-up of a USD two billion fund of funds dedicated to supporting business angels and to funding public programmes. This would be an extension of the Small Business Administration (SBA) programme, which has experienced difficulties in staying afloat. Unfortunately, the *track record of public funds of funds is bad* (Arnold, 2009b), notably because of the proximity effect and the local political agenda which affects public investment structures (Bernstein, Schoar & Lerner, 2009), whether they are sovereign wealth funds or funds of funds. In the UK, state-backed venture capital funds have underperformed by comparison with their commercial counterparts. The returns of the latter (2002–2004) were 7.7% whereas all VC funds (commercial and public) of the same vintage were 1.7%.

Thus, *statistics of private equity performance and activity should be read with caution*. They are the result of periodical polls of private equity fund managers answering on a voluntary basis. These figures are not audited; they cover a different sample of funds over time depending on the answer rate, and are applicable in any case to only a portion of the private equity industry.

KNOWING THE DEVIL TO CIRCUMVENT IT

This book will (unfortunately) not be able to avoid the above-mentioned traps completely. I am a prisoner of the same constraints my peers have had to deal with (see Cartoon I.2). The value of the book, if there is one, could be that it was written with these limits in mind. This gives the content a critical perspective which could thus highlight its originality. I will keep in mind the need not to be totally blind to the bias conveyed by the data I am using.



Cartoon I.2 Writing a book about private equity and taking the time to enjoy it

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The second reason why this book differs from the rest lies in its approach to private equity financing as a cycle, and not a static body of financial practices. Two factors motivate this approach:

- *Private equity has been attracting an ever increasing amount of capital* over the course of the last two decades. This capital inflow has contributed to changing the dynamics of the sector, its structure, its practices and its influence on the overall economy over the course of only four to five business cycles (that is to say on average three years of economic growth and two years of recession). The source of this inflow, notably pension funds, has also exposed the private equity sector to exogenous influences as its visibility has increased.
- *Private equity players are constantly innovating and at a fast pace.* This innovation potentially explains the persisting gaps between the academic literature and the daily activities of practitioners, as the scientific body struggles to catch up with the pace of innovation. Unfortunately, the lack of available data does not help the work of the scientific community.

Because private equity is evolving constantly and rapidly, it can only be captured partially by a single book. For that reason, dear reader, this book will focus on identified trends; practical and theoretical dialogue; and draw some hypotheses to guide you towards an understanding of upcoming events.

This book will be structured to identify the critical elements that have shaped the private equity industry (Chapter 1) and which remain necessary for those countries willing to establish this industry (Chapter 2). Once these founding parameters have been analysed, we will see how the private equity sector is organised as an ecosystem (Chapter 3) centred on the entrepreneur and the lifecycle of companies (Chapter 4). In that respect, the investment process and the

entire private equity activity is based on interpersonal relationships and on arm's length interactions (Chapter 5). These conclusions will allow us to distinguish the trends and fads affecting an activity in 'teenage time' (Chapter 6), before examining the responsibilities (Chapter 7) that the sector will have to handle. The Conclusion will provide some prospective analysis.

Contents

Foreword	xi
Acknowledgements	xiii
About the Author	xv
Introduction	xvii
A moving target	xviii
A consubstantial lack of information	xviii
Benign neglect, malign consequences	xix
Knowing the devil to circumvent it	xx
PART I WHAT IS PRIVATE EQUITY?	1
1 Private Equity as an Economic Driver: An Historical Perspective	3
1. Pooling interests to identify and exploit sources of wealth	5
(a) Identify, control and exploit resources	6
(b) Leverage public policies and a favourable business environment	8
2. Championing entrepreneurship	9
(a) No private equity without entrepreneurs	10
(b) Convert ventures into business successes	12
(c) Entrepreneurship and private equity form a specific ecosystem	14
Conclusion: an attempt at definition	15
(a) A negotiated investment in equity or quasi-equity	15
(b) A fixed maximum term	16
(c) Implying specific risks	16
(d) With high expected returns	16
(e) Undertaken on behalf of qualified investors	16
2 Modern Private Equity – A French Invention?	19
1. USA: the foundry of modern private equity	20
<i>The strict separation of public policies and public financing</i>	20

The separation of public endeavours and private efforts; the subsequent support of the former for the latter	20
(a) Governmental input: SBA, DARPA and ERISA	21
(b) Universities, defence and disruptive innovation	22
(c) Challenges	23
2. Europe: adapting a successful model or creating its own?	24
(a) Governmental input: legal changes, tax rebates, infrastructures and EU market	25
(b) National champions, information technologies and incremental innovation	28
(c) Challenges	33
Conclusion: Emerging markets, building castles on sand?	38
PART II THE PRIVATE EQUITY ECOSYSTEM	41
3 Private Equity: A Business System Perspective	43
1. We are all investors in private equity	43
(a) Sources of capital	43
(b) Private equity investment rationale	47
2. Organisation and governance of private equity funds	53
(a) Private equity fund managers are financial intermediaries	53
(b) Incentives and fees	54
(c) Conflicts of interest	57
(d) Power, checks and balances	60
3. Measuring performance, managing risks and optimising returns	61
(a) Measuring performance in an uncertain context	61
(b) Managing risks and optimising returns	66
4. Pitfalls and challenges	71
Conclusion	74
4 The Universe of Investment	75
1. Venture capital: financing company creation	77
(a) Venture capital investment targets	78
(b) Actors and structures	78
(c) Operational activities	80
(d) Challenges	81
(e) Limits	84
2. Growth capital: financing companies' expansion	84
(a) Growth capital investment targets	84
(b) Actors and structures	85
(c) Operational activities	86
(d) Challenges	86
(e) Limits	87
3. Leveraged buy-out: financing companies' transmissions	87
(a) LBO investment targets	87
(b) Actors	87
(c) Operational activities	89

(d) Challenges	90
(e) Limits	92
4. Other interventions in private equity	95
(a) Targeting the stock exchange	96
(b) Turn-around capital and special situations	99
(c) Distressed debt	99
(d) Quasi-equity instruments (mezzanine) and second lien debt	105
(e) Merchant banking, investment banking and private equity house intervention	117
(f) Secondary market	118
(g) Real estate, infrastructure and exotic assets	120
Conclusion	122
5 The Process of Investment: A Matter of Trust and Mutual Interest	125
1. Step 1: Preliminary analysis	126
2. Step 2: Valuation	126
3. Step 3: Negotiating	127
4. Step 4: Structuring	129
5. Step 5: Complementary due diligences	131
6. Step 6: Transaction	131
7. Step 7: Monitoring and exit	132
Conclusion	133
PART III PRIVATE EQUITY IN TEENAGE TIME: TREND SETTING, FADS AND RESPONSIBILITIES	135
6 Private Equity Evolution: Trends or Buzzes?	137
1. Is private equity going mainstream?	137
2. Is private equity (still) creating value?	140
3. Private equity: between bubbles and crashes	144
Conclusion	148
There is no such thing as 'capital overhang'	149
7 Private Equity and Ethics: A Culture Clash	153
1. Greed	153
2. Destruction	157
3. Philanthropy	162
4. Transparency	163
5. Confidentiality and self-regulation	164
Conclusion	167
General Conclusion – Private Equity Today and Tomorrow	169
1. Core target: manage the volatility of performance	169
2. The only valid leitmotiv: long-term thinking	172
3. The <i>impact</i> of the fair market value	174
4. A long-term trend: the attractiveness of private equity	176
5. Private equity: future victim of its own success?	179

6. The impact of a better knowledge of private equity	184
(a) Understanding the risk and managing the J-Curve	184
(b) Innovating through structuring	185
(c) Private equity and universal owners	186
(d) Change or die: the pressure on general partners	188
(e) Regulation: Damocles' sword looming over private equity	189
Glossary	193
Bibliography	203
Index	207

Part I

What is Private Equity?

Whenever a company needs financing, two solutions come to mind: the stock exchange and bank loans. The stock exchange is a limited solution. It provides only access to funding for medium- and large-sized companies that meet specific criteria (sales figures, total of balance sheet, minimum number of years of existence, etc).

The conditions for taking out a loan are also strictly defined. Companies must prove their ability to pay back the bank in fixed instalments, which means that they must show a certain term of existence, stability of cash flows, healthy activity and also a limited existing indebtedness.

If neither the stock exchange nor banks finance business creation and development, then who, or what, does? Where does the money come from to finance the transmission or take-over of family businesses, for example? Or to restructure an ailing business? It is 'private equity' for that matter.

The expression 'private equity' was coined by reference to equity which is not listed and whose exchange is not regulated (Chapter 1). However, this definition only partly reflects the scope of action of private equity players, which has diversified and spread considerably (Chapter 2).