FINAL

Private Equity: now we're still here, what does the future hold?

The western financial services sector has survived a near fatal shockwave, not seen for over 70 years. While I hope we'll never see such a shockwave again, I am sure we will - and we probably won't be so lucky next time.

- Academics and finance experts are continuing to try to understand what exactly went wrong in order to learn lessons. However, while their studies fill bookshelves and disk drives, the basic financial structure of Western financial institutions remains largely unchanged, in contrast to the thirties when radical changes were made.

Today I want to talk about where I think this leaves Private Equity, both GPs and investors.

There were many pundits all around the world who proclaimed the death of Private Equity in 2008. Surprising such naysayers, Private Equity has proved resilient, bouncing back.

- Last year in particular turned out much better than expected with many Private Equity funds rebounding from their lows as valuations improved. Despite a sovereign debt crisis that swept across Europe, the global economic environment proved relatively benign, after several years of upheaval. The global financial markets showed signs of life, recovering from the lows of March 2009 and providing more liquidity in most markets.

- Drawing on the rebound in 2010, most investors started 2011 with a healthy amount of optimism. They saw more positive signs: financing returned; dry powder was plentiful; prospects of strong returns surfaced; and Private Equity was, once again, winning favour with investors.

•The Western consumer remains fragile and understandably nervous; Western governments continue to try and scale back fiscal spending but are not making real in roads with the West continuing to substantially overspend; while at the same time, unemployment remains far too high, particularly amongst the young, and shows no sign of abating. Rising energy, commodity and food prices are squeezing economies. The West, financed by the East, is hence in a quandary as to what to do, with decisions made more difficult by the extraordinary political turmoil in the Middle East, and the terrible tragedy in Japan. These developments have increased uncertainty and boosted volatility.

My view, however, on where we are today and what the future holds for us is more cautious.

• This is the reality and it underpins my belief that expectations for 2011 have been too optimistic.

• Since 2009, the private equity industry has done remarkably well - who expected this back in 2008? But the proof is there for all to see: KKR, Permira, Blackstone and, indeed Terra Firma, have recently posted performance numbers pointing to a strong rebound in their portfolio companies. However, it would be wrong to conclude that we, the private equity industry, single handedly saved ourselves.

• First, the TARP programme gave all the US big banks the capital they needed to restructure their US loans and allow the PE firms they dealt with to repurchase debt at deep discounts.

• Second, the European Government backed support for European banks allowed them to adopt an “amend and extend” approach for a lot of creditors, pushing back the day of reckoning and giving Private Equity a vital lifeline.

• Finally, the central banks kept interest rates low, and pumped the Western financial system with liquidity.

A fairer conclusion is that Private Equity and, indeed the whole financial services industry, was given three very valuable “get out of jail” cards.

• These three factors combined to make our businesses and our portfolios look a lot better today than we ever thought they would back in 2008. But in truth we, in Private Equity, didn’t have as much to do with the rebound as some are tempted to claim. The next time things go wrong there will be no “get out of jail” cards as the central banks have neither the resources nor the political will to provide them again.

So where does that leave the private equity industry now and for the future?

- I have long said that for most Western economies I can't see a meaningful recovery occurring until at least 2013.

- So much has happened in 2011 already that is weighing on the Western economies. We have already experienced tumultuous change in the Middle East. Conflict and chaos persists in Libya, Syria and Yemen and political unrest in the region is likely to continue. This has the potential to tip us from a teetering recovery into another recession.

- Yet as remarkable and historic as the events have been in the Middle East, there is a bigger threat to returns, and our economic well being: the age-old enemy of investors and destroyer of wealth: I'm talking here about inflation.

- People tend to look to the past to help determine what will happen to economies and investments going forward. I suspect many will draw from the experiences of the OPEC-induced oil shock of the 70s and the response of central banks and governments in the West in the 80s to guide them today.

- The pressure today comes from the insatiable appetite for commodities in the emerging markets. Here I speak primarily of India and China, China being now the second largest economy in the world. These two countries are developing at break neck speeds. By 2025 some demographers predict that China will have 219 cities with more than one million inhabitants. That compares with 35 in Europe today.

That would be a mistake.

The driver of inflation this time is very different and my fear is that we in the West do not have the resources to break the new emerging inflationary cycle.

- The West simply does not have the power to control inflation of this nature and, more importantly, countries like China and India are unwilling to pause for breath to help us.

- The average Western consumer and our respective governments are poorly positioned to adapt and prosper in this new world. The West would need to make a large number of changes in areas like pension obligations and employment regulations both of which would be highly unpopular electorally, in order to start to make themselves competitive with the emerging markets. Only recently, Ratan Tata, the Chairman of the giant Indian conglomerate, TATA, said that workers in Britain were unprepared to work as hard as their counterparts in India. He has decided to close steel plants in Scunthorpe, England and move more highly skilled jobs to India.

Jnfortunately, I've got more tough news:
 believe life for most Private Equity GP's will be harder and less rewarding inancially than it was in the past.

· As an industry, we face the prospect of there being no equity carry earned rom funds established in 2006.

· Raising new funds will be far more difficult and most will have to settle for unds that are half the size of what could have been raised during the credit boom.

· It will also be harder than before for new Private Equity firms to establish hemselves and due to regulatory changes it will cost far more to start a new firm.

·While for all GP's public scrutiny will ncrease substantially and public elations disasters, like Southern Cross n the UK, will provoke Governments to urther regulate our industry.

So, times look set to remain tough for the foreseeable future in the West. For those of us here in this conference hall, what does it mean?

Let's start with GPs.

But there is some good news for GPs:

• Importantly, a lot of dry powder is out there still to be used so GPs' are not facing an immediate financial crisis - at the current rate it will take two to three years for the dry powder to be invested and the fee income from that will last for many years.

• And, despite the challenges we face, it is possible for GPs to make excellent returns by investing this capital wisely.

•However, we need to face the reality that for all but the largest LPs our current business model is going to need to change to adjust to a world where we will not be growing and have to live off smaller funds.

So where and how should GPs invest?
I think the frenetic deal-making pace of 2006-2007 offers some important lessons for us today.

- The sellers of large businesses want to continue running highly competitive and swift auctions as they did in 2006 and 2007 to maximise price, and investment banks want private equity to commit to deals quickly so they can continue to lock in their fees and get deals syndicated quickly. We, as acquirers, therefore must give our investors every possible advantage by gaining a level of exclusivity and insisting on having the time to ensure that the financing is locked in and robust.

- We should also focus on the alternatives to large deals. Besides smaller deals GPs also ought to look at making investments that consist of deals pieced together bit-by-bit and held onto as long as returns are above the implied long-term cost of capital.

- GPs, in focusing on these types of opportunities, need to improve the operating performance of the business and determine a new strategic direction, as this will drive returns for investors.

• Granted, operational and strategic changes take time. There are no quick fixes, because simply hiring people or coming up with a new business plan is not the same as making effective, sustainable change.

• However, returns generated through these activities will be rewarding even in this difficult and competitive market.

GPs need to be in control of their portfolio companies, and take direct responsibility for formulating the business plans for their portfolio companies.

• Looking at Terra Firma's portfolio, Infinis, a business we have grown over 7 years is a good example of what I'm talking about. We have built a green energy business by taking an orphaned land fill gas operation and making major operational improvements, as well as transformative acquisitions. This business is now going on to be 10 times the size it was when we bought it and ir is very profitable; making many many times the money we invested in it.

• I believe we're at a seminal moment for LPs, when they can no longer put off taking what is a tough decision:

•That is, what is the best way for them to invest their money in Private Equity?

•The first option is to treat Private Equity, to all intense and purposes, as a commodity asset class.

•That is to say, "I want exposure to Private Equity and I'm prepared to take mean performance but I want to invest simply and in size". For these investors, what should they do?"

Turning to LPs, what does the future mean for them?

• Frankly, the obvious bet is to give their money to one of the global alternative investment franchises, such as a Blackstone. They can then allocate their investment across its various products and trust in its brand.

•These firms have built world-class asset management operations and, as an investor you have access to a large range of products.

- The second option is for investors to ɔuild their own portfolio of smaller GPs. True, this option carries greater risk, particularly "career" risk for those professionals willing to recommend and invest in lesser-known or smaller funds. However, I believe this strategy potentially offers significantly greater rewards than that achieved by investing with the largest franchises.

However, there is a long-term problem with this model. To feed it and keep their public shareholders happy the global franchises need to keep raising more and larger funds and bigger deals, which means that their flagship funds are likely to become mediocre over time as has traditionally been the case for all other global asset managers. The other big issue is that these large global private equity asset managers are attracting more and more attention from regulators and regulation of their businesses could reduce returns sometime in the future.

- These are the two options for investors and it probably comes as no surprise that I would construct my own portfolio if I was an LP. Properly constructed, the "DIY" approach should produce greater diversification, and offers the opportunity to invest a large proportion of available capital with specialists. In my view, it is the non-public private equity specialists who offer the best opportunity to generate extraordinary returns.

- A contrarian portfolio is by definition unconventional, and thus largely incomparable to the vast majority of institutional private equity programmes

- If building my portfolio in today's environment I would favour specialisation in real asset investors and locally based mid cap firms over global investors and large buy-outs.

As a devout contrarian, I would undoubtedly construct a private equity portfolio with a strong contrarian bias, although I recognize that this approach takes a certain level of courage.

- I would be looking for geographic specialisation. If I was looking for exposure to an emerging market country such as China then I would want someone who's there on the ground, who understands the culture, and gets the whiff of a new opportunity before anyone else. In short, I'd look to work with someone who was born, lives and will die in China.

Finally - and for me this is red line issue - I would walk away, unless the Senior General Partner, the person running firm, was investing significant amounts of his own money in the fund. Terra Firma is as committed as it is to maximizing every penny it has invested in every one of its deals for its investors, because it's the biggest investor. In the end, as so often in business, the number one determinate as to who to partner with comes down to alignment of interest.