Twenty-Five Years of Change in Private Equity

By Laura Kreutzer and Russ Garland
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When Private Equity Analyst began publishing in 1991, Wall Street was still reeling from the collapse of Drexel Burnham Lambert and the nation was knee-deep in an economic recession. Back then, the private-equity industry still was a relatively small niche group of investors. Today, it has grown into a sophisticated asset class that has become an important contributor to the capital markets. Outlined below are some of the biggest changes the industry has undergone along the way.

The Industry Supersizes

What used to be a clubby community of deal makers bootstrapping buyouts in the 1970s and 1980s now accounts for a much larger percentage of global capital markets. As the capital markets matured and the number of debt providers proliferated, buyout firms have been able to pursue more deals, including large, sophisticated transactions.

“The plumbing was never working the way it needed to work until the ‘90s,” John Connaughton, a co-managing partner at Bain Capital, said of the debt markets evolution. Private equity’s superior returns attracted more investor dollars to the asset class, in turn pumping up fund sizes.

Private Equity Analyst wrote in 1997 of the abundance of $1 billion-plus buyout funds and of concerns such funds sparked among limited partners, who cited fewer large deals available to absorb all the capital and fears managers would stray from the strategies that previously made them successful. A decade later, however, many of those funds turned about to be strong performers, and buyout firms were able raise funds that came in north of $10 billion, with Blackstone Group LP closing its Blackstone Capital Partners V LP fund at a record $21.7 billion in 2007.

That same year, U.S. private-equity deal volume accounted for 28% of total U.S. merger and acquisition dollar volume, compared to just 4% a decade earlier, according to data provider Dealogic Ltd.

Although both fund sizes and deal values have come down from the height of the buyout boom, both the multibillion-dollar deal and the multibillion-dollar fund remain fixtures in the industry and aren’t likely to go away any time soon.

More Firms Go Public

Since the early 1990s, the private-equity industry has grown a lot less private. For much of its early history, the industry seemed to relish its low profile. Outside of a handful of listed funds of funds and Canadian buyout shop Onex Corp., private-equity firms didn’t entertain public listings.

In fact, firms often touted the benefits of private ownership and the long-term investment perspective that came with it when wooing public company executives. In 2001, Carlyle Group LP seemed to have its eye on an eventual public offering when it sold a stake in the firm to California Public Employees' Retirement System, although fellow buyout shop Blackstone would ultimately beat it to the public markets with its initial public offering in 2007.

The 2008 collapse of the financial markets and the recession that followed delayed other firms from braving the IPO waters until 2010, when KKR & Co. listed, followed by Apollo Global Management LLC in 2011 and Carlyle and Oaktree Capital Group LLC in 2012. Going public has provided firms with a permanent source of balance-sheet capital they can use as currency to expand into new markets or strategies and even to acquire other firms.

However, managers of listed firms have expressed frustration that public investors often undervalue their stock, and some LPs say they worry publicly traded firms will sacrifice returns at the expense of chasing asset growth.

The Industry Outgrows Private Equity

Back in the early 1990s, most private-equity firms did just one thing: private equity. As the industry grew, however, firms found they could apply their expertise in different industries to other investment strategies and asset classes, the most popular of which has been private credit.

Some of the largest firms, particularly publicly traded ones, have multiple business lines that span real estate, secondary investments, public equities, capital markets advisory, natural resources and more. Those new business units have enabled firms to expand and diversify their income streams and made them less susceptible to cyclical downturns in any single asset class.

Private Equity Goes to Washington

Unlike the venture-capital industry, buyout and other corporate finance firms saw little need for a collective voice in Washington, D.C., for much of the 1990s and early 2000s. But as the buyout boom kicked into high gear in the mid-2000s, the industry attracted greater public scrutiny and criticism for some of its practices. In 2006, a group of large private-equity firms decided to form a trade organization to promote industry interests in Washington, particularly as the asset class was subjected to greater regulatory oversight.

The American Investment Council officially launched as the Private Equity Council in 2007 and has since expanded to include more midmarket firms among its members. The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 forced many private-equity firms to register as investment advisers with the Securities and Exchange Commission.

Other laws such as the Alternative Investment Fund Managers Directive in Europe also have affected the way firms operate, although to varying degrees.

"It's something we have to deal with, particularly in fundraising, but the fundamental elements of our model have not been impacted to a such a degree that it encumbers what we can do," said David Mussafer, a managing partner at Advent International Corp.

The Rise of the Operating Model

Unlike the 1980s and 1990s, private-equity firms today cannot live by financial engineering alone, despite an abundance of cheap credit. The need to grow portfolio companies by expanding earnings drove more firms to bring in teams of industry experts as operating partners, a trend that intensified during the financial crisis of 2008 and 2009.

Although the U.S. economy has improved considerably since then, private equity's emphasis on operational improvements and its use of operating partners remains an industry fixture.

"Ten years ago, they had operating partners that sat on boards, but it was really a board governance role," said Nick Leopard, founder and chief executive of operational advisory firm Accordion Partners. "Then firms started putting operating partners on staff, and they got really involved with portfolio companies. Now everyone's got three to five operating partners on staff."

Private Equity Discovers ESG

For years, "doing good" in private equity meant generating the highest possible returns for one's LPs. Many private-equity firms believed (and still believe) that generating strong returns while also generating social good were two mutually exclusive goals.

But over the past decade, more LPs have pushed their fund managers to consider environmental, social and governance factors into their due diligence and portfolio management. In 2006, a group of institutional investors supported by the United Nations launched the Principles for Responsible Investment, a framework of six principles outlining best practices for ESG issues.

A small but growing number of private-equity firms also launched their own efforts to measure, monitor and improve different ESG factors as part of portfolio company management and, later, due diligence. These firms found that addressing these factors also saved them money and boosted their bottom lines.

More investors, particularly those in Europe, factor ESG considerations into their fund due-diligence questionnaires, and the PRI had more than 1,500 signatories as of August 2016. Although the overall percentage of private-equity firms with formal ESG programs remains relatively modest, pressure from LPs promises to keep ESG issues on general partners' radar screens.

Venture Capital Grows Up

Venture capital also has matured in the past 25 years, from a small, little-understood business to a legitimate asset class whose portfolio companies are important players in the world economy. In 1992, when VentureSource, a data provider owned by PEA publisher Dow Jones & Co., started tracking the industry, there were 882 financing rounds for U.S.-based venture-backed companies that raised $3.18 billion.

Last year, there were 4,115 rounds, garnering $75.29 billion. Some of that money went to household names such as ride-hailing service Uber Technologies Inc. and room-rental service Airbnb Inc. The industry is led by heavyweights such as Andreessen Horowitz, Greylock Partners, New Enterprise Associates and Sequoia Capital, which have billions of dollars under management. Some of them invest globally, financing companies in China, Europe, India and elsewhere.

ACCORDION

Venture capital has become more sophisticated, with a vibrant secondary market for shares in startups and venture funds. Mutual funds and other public-market investors pay close attention to venture-backed companies, often participating in later rounds. At the early stage, a fresh crop of investors and online investment vehicles such as AngelList offer new avenues for supporting startups.

"What is different is the breadth and the size and the global nature of it," New Enterprise Associates co-founder and Chairman Dick Kramlich said of the venture business. What hasn't changed is "it's still a roller coaster. We're in a roller-coaster business."

The Push for Diversity

Twenty-five years ago, the face of private equity was almost overwhelmingly white and male.
Although that's still the case at many firms, more women and people of color have broken through the glass ceiling of private-equity leadership. Two decades ago, for example, few, if any, women held senior positions at the nation's buyout and venture-capital firms. Today, not only have women entered the industry's senior ranks, but a growing number have struck out to launch their own firms or co-found such firms alongside other professionals.

Aspect Ventures, Kainos Capital and Oak HC/FT Partners are only a few such firms that have emerged in the past five years. In the past two years, large firms such as Blackstone and KKR also have introduced human resource policies aimed at promoting retention among their female ranks, such as longer paid maternity leave and travel policies that allow employees to bring young children and caretakers with them on business trips.

The industry seems to have made less progress on cultivating racial diversity in its workforce, although a small number of firms including Carlyle and TPG have helped set up programs aimed at attracting more minorities into private equity.

"Decision-making science suggests that the more diverse a group is, the better decisions it will make, and we believe that," said Kevin Callaghan, a managing director at Boston-based Berkshire Partners, where women account for five of the firm's 24 partners. Of course, many say that the industry still has a long way to go when it comes to gender and racial diversification.

Secondary Deals Lose Their Stigma

When we published our first issue of PEA, the secondary market was still in its infancy. A number of secondary firms got their start in the late 1980s to mid-1990s, including Landmark Partners, Coller Capital and Paul Capital. Back then, an LP selling its stakes generally signaled that the LP was either exiting the asset class or a specific subsector, such as venture capital, or that it was under financial pressure to sell.

Over the next two decades, however, more investors began to utilize the secondary market to actively manage their portfolios, adjusting their exposure to specific strategies and managers or even cleaning out tail-end funds. Secondary deal volume started to grow dramatically in 2010 as the market began to climb out of a recession, and the gap between seller and buyer expectations narrowed.

Deal volume topped $40 billion in 2014, according to estimates from several intermediaries, a record that was nearly matched in 2015. Deals appear to be off to a slower start this year, largely due to a smaller number of $1 billion-plus transactions. However, secondary buyers say LP acceptance of secondary deals as a portfolio management tool, a growing volume of GP restructuring deals and a massive backlog of fund commitments all promise to support a steady flow of deals in the years ahead.

Firms Prepare for Succession (Sometimes)

Back in the early 1990s, the buyout industry was still young, and few firms felt pressure to prepare for life beyond the firms' founders. As the industry matured, however, succession planning rose much higher on the priority list, at least for investors.

LPs often want to see that firms are grooming the next generation and promoting stability among their ranks before signing onto a new fund. A small but growing number of investors, including LPs, are willing to buy stakes in GP management companies, offering founders a way to monetize the equity in their firms to pave the way for the next generation of leadership.

"The past 25 years of the private-equity business reflect the maturation of a very successful industry created by a bunch of talented people," said Howard Newman, chairman and chief executive at Pine Brook Partners. "It's in the process of moving from the founders' era to the next generation."

Emerging Markets Private Equity Finally Emerges

Twenty-five years ago, the idea of raising funds of funds devoted exclusively to Africa, Asia or Latin America was a pipe dream. In the 1990s, even Western Europe represented a newer frontier for the asset class.
Over the past decade, however, strong economic growth in many emerging markets economies spawned a community of home-grown private-equity firms in those regions. Private equity's growing reach in these markets also gave rise to specialized trade groups looking to educate investors about emerging markets private equity and promote the industry's interests.

Examples include the Emerging Markets Private Equity Association, the Latin American Private Equity and Venture Capital Association and the African Private Equity and Venture Capital Association. North America remains the largest private-equity market both in deal volume and fundraising volume, followed closely by Western Europe.

But despite currency volatility, and political and governance risks, emerging markets private equity accounts for a growing proportion of investor portfolios. Overall, emerging markets private-equity fundraising hit $34 billion in 2015, according to the EMPEA. Although that's down from the $44 billion emerging markets private-equity managers raised the previous year, it still far exceeds fundraising levels in much of the 1990s.

Shadow Capital Comes Out of the Shadows

Since the 1990s, the number of LPs seeking direct investments or co-investments or devoting capital to managed accounts customized just for them has risen dramatically.

Driving the rise of this "shadow capital" is a heightened focus among LPs, particularly larger ones, on the high costs associated with building a large private-equity portfolio solely with co-mingled funds.

The industry's strong returns have also made it more difficult for bigger LPs to invest large amounts of capital efficiently without relying in some way on the use of this shadow capital. Placement agent Triago estimated that the volume of shadow capital reached $161 billion in 2015.