Supplementary Reading for

Chapter 9 Looking for Investments Outside Silicon Valley

A notoriously secretive industry is facing pressure to open up

Dec 18th 2003
From The Economist

A few years ago, the financial pages were full of stories about companies buying one another. They still are, even though big intra-industry mergers are currently rare. Today's purchasers have half-familiar names such as Blackstone, Carlyle or Newbridge: these are all private-equity firms, which buy businesses, both new and mature, with a view to sprucing them up and eventually selling them again. This week, for instance, Blackstone agreed to pay €3.1 billion ($3.8 billion) for Celanese, a German chemicals firm. The deal is the biggest involving a listed German company withdrawing from the stock exchange and going private.

Since 1980, estimates Venture Economics, a research firm, more than $1 trillion has been poured into private-equity funds (see chart). Once the industry was clubby and opaque, the preserve of rich families and private endowments. To some it looks sinister, especially when private-equity firms have former politicians on their boards, presumably for their connections.

In any case, these firms are facing growing pressure to be more open, and not just from conspiracy theorists. The main reason for this is the private-equity industry's own success. As it has grown, it has attracted a broader range of institutional investors, notably big public pension funds, lured by the prospect of decent profits not correlated with volatile stockmarket returns. Venture Economics reckons that pension-fund money accounts for two-thirds of current inflows. These institutions are themselves under growing pressure to reveal more information, and they need to know what their private-equity stakes are worth.

Awkward questions

When the technology bubble burst, pension funds were left with worthless stakes in private-equity deals that had gone sour, on top of the damage done by tumbling stock markets. Trade unions and other groups of employees have since been calling for more information from pension-fund managers about how workers' money is faring.

Those representing public employees (and inquisitive journalists) have been helped by state laws on the freedom of information.

In October, the University of California became the latest pension-fund investor, after state pension funds in California, Texas and elsewhere, to bow to legal pressure to release private-equity returns. It is still fighting to keep comments made during investment meetings out of the public domain. Some private-equity firms are hitting back. Rather than see public-sector investors release information, Sequoia, a Silicon Valley group, barred the Universities of California and Michigan from its newest fund and told them to sell their stakes in other funds. Other managers are giving less information to public investors, who are subject to state-disclosure rules.

A second reason for more openness is so far theoretical rather than real: the possibility of regulatory action. Already, hedge funds, also fast-growing and largely unregulated, have caught the attention of the Securities and Exchange Commission (SEC), which released proposed rules for such funds in September. So far the SEC has stayed out of private equity. But private-equity firms receive more public pension money than hedge funds do. Arguably, they are also more secretive, because hedge funds at least buy publicly traded securities (if in complicated ways).

So some in the private-equity business want to pre-empt rather than resist calls for more transparency. This month the Private Equity Industry Guidelines Group, a collection of big investors and private-equity funds, unveiled guidelines intended to help standardise the valuation of investments in non-listed companies. Currently, methods are not clear and vary between firms. Pension-fund investors complain that these can lead to huge differences in different private-equity shops' valuations of similar stakes in the same company.

The hope is that guidelines will make private equity more attractive to investors as well as staving off the possibility of external oversight. “With all the corporate fiascos of recent years, the regulatory climate has changed,” says one senior partner at a large buy-out firm, “No one wants the SEC pounding at the door.”

Outside America, the private-equity industry is less developed. There is also far less pressure from investors for greater openness. Curiously, however, Europe has had detailed valuation guidelines for years. These are still a work in progress—in Britain, an industry group is formulating the latest version—but Europe is nevertheless farther ahead.

Aside from the self-serving or understandable reluctance of private-equity firms to reveal more, there are also genuine conceptual difficulties in doing so. Ultimately, the only measure of a private-equity stake's value is what it fetches when it is sold. But a sale might be years away. Interim valuations, particularly in start-up companies, whose worth, if any, lies far in the future, are difficult. Fund managers' judgment may be the best guide. But fund managers often have an obvious incentive to err on the optimistic side. Even if they do not, different managers are likely to value the same prospect differently.

Meanwhile, there is a trend in accounting standards away from valuing assets at historic cost (i.e., what they cost to buy) towards fair value (i.e., what they would fetch if sold). On the plus side, this means that investments that have gone bad no longer stay on companies' books at grossly inflated historic-cost valuations. On the minus side, fair value depends largely on managers' subjective judgment.

How can this be improved upon? One idea, championed by Jeffrey Walker, of J.P. Morgan Chase's private-equity group, is to have a third party review valuations. The bank, as a publicly traded company, already does this for its own private-equity portfolio. Few in the industry favour this, though, arguing that private-equity managers should know better than outsiders what their investments are worth.

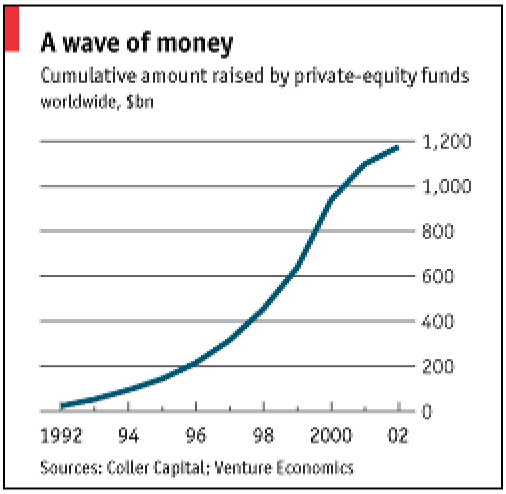
Another option might be to use prices in the secondary market for private-equity stakes and portfolios. The trouble is that the market is still too small to be much use, with only $3 billion-worth or so of equity changing hands annually. Much of this comes from distressed sellers, dumping their stakes cheaply to avoid having to meet their obligation to cough up more money when private-equity funds demand it. Other sellers are public companies that have decided to reduce their private-equity investments or to get rid of them altogether. Prices in such circumstances can also be depressed. Nevertheless, says Josh Lerner of Harvard Business School, “it's a step in the right direction.” He thinks the secondary market will help transparency in valuations as it matures.

The inevitability of visibility

Does transparency have its limits? Quite possibly: the business is called “private” equity for good reason. A lot of the investment goes into small, new firms, much of the rest into older companies that want to restructure out of public view. Most institutional investors understand this.

However, as the industry matures more transparent valuation tools are already being created. In America, some big financial groups have begun securitising their private-equity portfolios in order to clean up their balance sheets, get cash and reduce the capital they must set aside against equity investments. This requires valuation. In Switzerland, Partners Group and other innovative firms have devised bonds backed by private-equity and hedge-fund investments that are traded on exchanges and can be bought by retail investors for a few thousand dollars.

If private-equity funds want to keep growing at their present pace, they might one day want more retail money. In America, it is true, small investors are not yet allowed to invest directly in such funds. That could change; but a private-equity industry with a broad pool of investors would surely be watched more closely by regulators, and thus have to be more open. If that happens there won't be much “private” about the business any longer.



Questions for discussion:

1. What business do private equity firms do according the author of the text?
2. Why did the author say that the private-equity industry once was clubby and opaque?
3. What pressure are these firms facing to be more open?
4. What happened to the pension funds that had invested heavily in the private-equity funds when the technology bubble burst in early 2000s?
5. What is another reason for private-equity firms being openness?
6. Why is it conceptually difficult to measure a private-equity stake's value?
7. What possible consequences does the author notice that a trend in accounting standards will bring about to the valuations of the investments by private-equity firms?
8. Does the author describe a current trend showing more transparent valuation tools are already being created in the maturing industry?