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The Private Equity Council

Introduction

Mr. Chairman and Members of the Committee, thank you for giving me the opportunity to present the Private Equity Council's views on creating a forward looking approach to regulating the financial services sector in the aftermath of the system-wide financial crisis that has shaken so many investors, consumers, and institutions.

The Private Equity Council is a two year old trade association representing 12 of the largest private equity firms operating in the United States[1]. Our mission is to educate public policy makers on the positive role private equity investments have played in both strengthening hundreds of companies of all sizes and from all sectors of the economy, and in generating above average returns for scores of public and private pension funds and other investors that have allocated a portion of their portfolios to private equity funds. While PEC members are among the most visible and well known in private equity, each with more than $10 billion in assets under management, the Committee should bear in mind that there are more than 2,000 PE firms doing business in the U.S. The overwhelming majority of these are local firms doing small transactions that rarely attract much attention and yet help power local, state, and the national economies.

The Business of Private Equity

Before directly addressing the policy issues before the Committee, it is useful to describe briefly the private equity industry, how it works, and how it fits contextually into the financial marketplace.

A private equity firm, regardless of its size, creates funds in which it invests its own capital, along with larger amounts of capital raised from from third-party investors. In these partnerships, the private equity firm acts as the general partner, or GP, and the third-party investors are the limited partners, or LPs. In fact, highly sophisticated investors such as large public and private pension funds, endowments and foundations account for 70 percent of the funds invested with the top 100 PE firms since 2005. The 20 largest public pension funds for which data is available (including the California Public Employees Retirement System, the California State Teachers Retirement System, the New York State Common Retirement Fund, and the Florida State Board of Administration) have invested nearly $140 billion in private equity.

[1] Apax Partners; Apollo Global Management LLC; Bain Capital Partners; the Blackstone Group; the Carlyle Group; Hellman & Friedman LLC; Kohlberg Kravis Roberts & Co.; Madison Dearborn Partners; Permira; Providence Equity Partners; Silver Lake Partners, and TPG Capital

The PE firm (or GP) uses the partnership's capital, along with funds borrowed from banks and other lenders, to buy or invest in companies that it believes could be significantly more successful with the right infusion of capital, talent and strategy. Historically, PE-owned funds carry virtually no debt at the fund level. Private equity firms do use debt to acquire portfolio companies, but this debt is maintained at the portfolio company level. The typical capital structure of the companies acquired by a private equity fund is approximately 60% debt and 40% equity (though this proportion can vary based on the cost of credit, the economic outlook, and the nature of the business).

A key to the success of private equity investments is the requirement that both the PE firm (the owners/shareholders) and the senior managers invest their own money into the sponsored business. By definition, when you have your skin in the game, when your equity is at risk, you are highly incented to make decisions that will grow the value of your investment. Failure to do so means you lose your own money -- not just the investment of a faceless shareholder. In short, the PE model ensures that the interests of the shareholders (GPs and LPs) and the interests of management are fully aligned. In contrast to publicly-owned companies, PE owned companies can operate without the pressures imposed by public equity markets' focus on quarterly earnings and short-term gains. As a result, they make management decisions focused entirely on what is required to improve long-term performance and value.

In seeking companies to purchase or invest in, PE firms have focused on a number of broad categories, including: struggling and underperforming businesses such as Toys 'R Us or J Crew; unwanted divisions of large conglomerates, such as Dunkin Donuts or Burger King; promising or strong companies in need of venture or growth capital, such as NASDAQ or the online video service Hulu; and family businesses where the founders are seeking to transition beyond family ownership.

Regardless of the type of firm acquired, the objective is the same: increase the value of the business during the time that it is owned by a private equity fund. PE firms accomplish this by adding managerial expertise, making capital and R&D expenditures, expanding into new markets and developing new products, and making strategic acquisitions to create the scale required to compete and become market leaders. Importantly, the PE firms do not share in any profits unless and until they have paid an 8-10% per annum return to their investors.

<u>PE and Jobs</u>

Private equity funds have a proven track record of creating jobs. The World Economic Forum reported that before they were acquired, private equity-owned companies on average were losing jobs at existing facilities faster than their competitors. But by the fourth year of private equity ownership, employment levels at those companies had increased to above the industry average. It also reported that in the first two years of private equity ownership, private equity portfolio companies increased the rate of job growth at new U.S. facilities to six percent above the industry average.[2]

Ernst & Young (E&Y) reported that at eight out of ten private equity portfolio company's employment is sustained or increased over time.[3] And economists Dr. Robert Shapiro and Dr. Nam Pham found that large companies acquired by major U.S. private equity firms increased domestic employment by 13 percent between 2002 and 2005, a period when employment at all large U.S. businesses grew by only three percent, and manufacturing companies owned by private equity investors grew employment by 1.4 percent during the same four-year period, while employment in the overall manufacturing sector declined by 7.7 percent. [4]

PE and Performance and Value

According to E&Y, the value of U.S. businesses owned by private equity grew 83% during the years they were owned by PE firms, three times faster than their equivalents in the public sector.[5] E&Y also found that more than half of the earnings growth (before taxes, interest and capital expense) at PE-owned portfolio companies came from business expansion, not cost-cutting or new acquisitions.[6] And Shapiro and Pham reported that 85% of PE firms studied increased capital expenditures in the three years after the PE investment.[7]

PE Returns to Investors

Improving the performance of portfolio companies has enabled private equity firms to deliver above average returns for the pension funds and other limited partners that invest in their funds. Between 1980 and 2005, the top-quartile PE firms delivered average annualized net returns of 39 percent[8], significantly beating the S&P 500 and other indices. The overwhelming majority of these returns – 80% typically – is returned to investors in the form of profit. That 80% translates into real dollars -- $1.2 trillion to be exact -- the total profits distributed to pension funds and other investors worldwide from their PE investments between the early 1980s and 2008.[9] This massive infusion to public and private pensions serving teachers,

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[2] The Global Economic Impact of Private Equity Report 2008, "Private Equity and Employment," World Economic Forum, January 2008

[3] Ernst & Young, "How Do Private Equity Investors Create Value? A Study of 2006 Exits in the U.S. and Western Europe," 2007

[4] Shapiro, Robert and Pham, Nam, "American Jobs and the Impact of Private Equity Transactions," Private Equity Council, January 2008

[5] Ernst & Young, 2007

[6] Ernst & Young, Beyond the Credit Crunch: How Do Private Equity Investors Create Value? A Global Study of 2007 Exits - 2008

[7] Shapiro, Robert and Pham, Nam

[8] PEC analysis of data from Venture Economics and Bloomberg

[9] Preqin 2008 Global Private Equity Review

firefighters, policemen and other retired public employees strengthens the solvency of the pension system.

On a mark-to-market basis, PE investors have seen the current value of their investments decline due to the financial crisis. But since PE firms hold investments for the long term, the current valuation snapshot is of marginal utility in assessing the eventual returns likely to flow to investors. Many investments now marked down as a result of the recession are likely to recover and be profitable for LPs, though perhaps not as profitable as was the case in more robust economic cycles.

But despite lower valuations now, on a relative basis, private equity performance through the third quarter of 2008 still surpassed the performance of public equity markets. One year performance for private equity in the period ending September 30, 2008 was -8.2 percent, compared to -21.4 percent for the NASDAQ and -22 percent for the Standard and Poor's 500 index.[10] Importantly, as noted, these results do not reflect "returns" as these investments are still owned and as the economy improves and their value recovers, many will be sold at a profit.

The investment report of an actual LP is illustrative. In its just released Comprehensive Annual Financial Report, the Pennsylvania State Employees' Retirement System reported that in 2008 its PE investments declined 6.8% while its investment in domestic, global and international equities fell from 37.5% to 52.4%. Over the last 3 years, total returns from PE have been 17% compared to -10.5% for U.S. stocks and -11.0 for non-U.S. stocks.

PE Today

Like other financial institutions, the private equity sector has been adversely impacted by the recession and credit crisis. Restricted credit markets have effectively shut down the market for financing new acquisitions, and many portfolio companies are under stress as they manage through this recession. In this regard, the challenges private equity faces are similar to those that virtually every public and private business in the U.S. is addressing. The good news, if there is any, is that over the last decade top private equity firms have made a major commitment to adding very sophisticated management resources to their portfolio companies, thus allowing them to provide hands-on guidance both from an operational and capital structure perspective, especially in such perilous economic times. The combination of operational expertise and favorable financing terms should enable most portfolio companies in viable sectors of the economy to ride out the economic downturn without violating debt covenants that could force them into default.

To be sure, some portfolio companies will not survive this deep recession, just as is the case with dozens of public companies with household names like GM and AIG. Nonetheless,

[10] Thomson Reuters Private Equity Performance Index (PEPI)

bankruptcies associated with PE investments made in the 2005-7 period will create hardships on workers, communities, and investors, not to mention the PE firms that will lose tens or hundreds of millions of their own equity.[11] But the critical takeaway for the members of this Subcommittee is that the failures of individual PE-owned companies, while hardly trivial, do not give rise to the kind of systemic risk relevant to policy makers seeking to prevent global financial shocks.

Despite the challenges facing the industry, private equity is poised to play a constructive role in the economic recovery. Today, private equity firms have more than $450 billion in committed capital to invest. But that capital is mostly sidelined due to the credit crisis and the recession. This industry is poised to be part of the solution, whether it is helping to recapitalize the banking system or investing in companies that desperately need growth capital and management expertise. We will continue to support traditional U.S. industries like steel and manufacturing, while also providing capital for new companies that are developing green technologies and energy efficient products.

PE and Systemic Risk

As Congress evaluates issues relating to systemic risk, we think it is important that policymakers distinguish among different types of private capital. Private equity is just one form of private capital. Other private investment vehicles include hedge funds, real estate partnerships, and venture capital funds, among others. All these pools of capital have features in common. But there are also important distinctions between them. Accordingly, we believe Congress should focus on regulating activities, not what businesses call themselves.

In laying out its Financial Regulatory Reform program, the Obama Administration articulated three fundamental factors that trigger systemic risk concerns: (i) the impact a firm's failure would have on the financial system and economy; (ii) the firm's combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and (iii) the firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system. <u>Private equity contains none of these systemic risk factors</u> and thus should pose little concern for policymakers seeking to develop a new regime to guard against catastrophic, cascading financial shocks. Specifically:

- PE firms have limited or no leverage at the fund level (as distinct from leverage maintained a the portfolio company level for a particular acquisition). Thus, PE funds are not subject to unsustainable debt or creditor margin calls.

[11] That said, according to a World Economic Forum study of PE investing over 20 years, private equity-owned companies defaulted on debt obligations at a rate substantially lower than all U.S. companies that issued bonds – and much lower than companies that issued high-yield debt.

- Private equity funds typically use 3:1 leverage for acquisitions compared to companies like Lehman Brothers, which was levered at 32:1 when it failed. Further, Lehman's leverage was maintained at the parent company level, thus exposing the entire firm to collateral calls.
- PE funds do not rely on short-term funding. Rather, private equity investors are patient and commit their capital for 10-12 years (or more) with no redemption rights. Therefore, investors cannot withdraw their money on short notice, triggering "asset fire sales" to find cash to make the repayments.
- PE firms are not deeply interconnected with other financial market participants through derivatives positions, counterparty exposures or prime brokerage relationships.
- Private equity investments are not cross-collateralized, which means that neither investors nor debt holders can force a fund to sell unrelated assets to repay a debt. In a sense, private equity investments are firewalled from one another so that any nonperforming investment does not negatively affect another investment. Losses are limited to the underlying value of the original investment.
- Private equity funds invest in long-term illiquid assets that are typically operating companies. Private equity does not invest in short-term traceable securities, like derivatives, swaps or equities.
- Private equity investments are diversified across multiple industries and there is no over-exposure to any single sector.
- PE firms are not a source of credit to households, businesses, or governments, nor do they act as a primary source of liquidity for the financial system.
- PE companies' borrowing is still a small portion of the overall credit market, well under five percent of all U.S. credit market obligations outstanding. The total value of all private equity holdings is equivalent to just 2.6 percent to 4.3 percent of corporate stocks and 3.1 percent to 5.3 percent of GDP.

<u>In short, when applying the Administration's systemic risk factors to private equity, it is hard to see how any particular private equity fund could be considered a systemic risk.</u>

<u>Financial Services Reform Issues</u>

The goals of financial regulatory reform should be to restore confidence in financial markets generally and the credit markets in particular, and to protect our financial system from the kind of meltdown that has devastated the global economy. We believe the Obama Administration's plan can accomplish these objectives. Although we do not have a direct stake in many specifics of the plan, we do feel very strongly that Congress should take deliberative action to provide clarity to market participants

More specifically, we support creation of an overall systemic risk regulator capable of acting decisively in a crisis, empowered to implement needed policies, and possessing sufficient international credibility to instill confidence in global markets. If the systemic risk regulator finds that an activity, an institution, or a class of institutions is systemically significant it should be empowered to examine and require reports, and promulgate rules on capital adequacy, operational controls, information and audit systems, and credit risk or other significant risk exposure. Further, the systemic regulator should be granted enforcement authority powers to take actions deemed necessary to protect the financial system.

Regarding private equity specifically, as I said PE does not have the potential to create the kind of systemic shocks that contributed to the financial crisis. Therefore we do not believe this form of investment poses significant concerns in the context of the financial regulation debate. As the Committee knows, the Administration's plan calls for private equity firms to register as investment advisers with the Securities and Exchange Commission. Subcommittee Chairman Reed has introduced S.1276, the Private Fund Transparency Act of 2009 which has a similar goal. <u>We generally support the registration requirements contemplated by the Administration and S. 1276</u>.

Registration will result in new regulatory oversight for many private equity firms. There are considerable administrative and financial burdens associated with record keeping and audits as registered investment advisors. These could be especially problematic for smaller firms. Given the fact that PE firms are not a cause of systemic risk, these additional regulatory requirements are arguably unnecessary. That said, we are mindful of the fact that excluding any asset class from the new regulatory regime could contribute in some way to diminishing confidence in the effectiveness of new regulatory regime and therefore we support the casting of a wide net.

While supporting the concept of registration and data collection from market participants including PE firms, we do believe Congress should direct regulators to be precise in how new regulatory requirements are calibrated so the burdens are tailored to the nature and size of the individual firm and the actual nature and degree of systemic risk it may pose. In this regard, we were pleased that the Administration's White Paper explicitly acknowledges that some of the requirements created by the SEC "may vary across the different types of private pools." We commend Chairman Reed for his sensitivity to this point in his own bill. Further, it is absolutely vital that any information provided to the SEC pursuant to a new registration requirement be subject to strong confidentiality protections so as not to expose highly sensitive business and financial information beyond that required to carry out the systemic risk oversight function. We stand ready to work with Chairman Reed on these and other provisions in S. 1276.

Conclusion

Mr. Chairman, according to research by Dr. Robert Shapiro, private investments typically rise during recessions and continue to rise during the initial years of recovery. Further, Shapiro reports that total private equity investments grow much faster during the initial year of recovery than overall business investment and there is some evidence suggesting that private equity-held firms create jobs during the initial stages of recoveries while employment across the economy continues to contract.[12]

[12] Shapiro, Robert, The Role of the Private Equity Sector Promoting Economic Recovery, Private Equity Council, March 2009

Today, private equity firms have more than $450 billion in committed capital to invest. This industry is poised to be part of the solution. That is our business, it's what we've done in the past, and it is what we will do in the future.

As Dr. Shapiro wrote, "In good and bad times, the core business of private equity funds is to identify firms with long-term potential for higher productivity, sales and profits; secure the capital to purchase these firms; and inject additional capital, improve their strategies and reorganize their operations, to achieve higher returns. Public policy should support these activities, especially during the current crisis, and refrain from imposing additional burdens that could hamper these activities or redirect them to other economies."[13] We believe the Administration's financial reform plan strikes a good balance between regulating PE while still allowing it to play its historically valuable role in making American companies stronger and more competitive.

Thank you.

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[13] Ibid.