



Schmidt-Gothan

Over time, private equity has evolved from entrepreneurial principal investing into one of many flavours of investment banking.

*Historically, high-net-worth individuals invested parts of their wealth in individual enterprises, taking an active role in their investments.*

“Private equity” originally meant just that: an individual or a group of individuals (often a family) investing private money as equity into an enterprise, often taking an active role in management or in the board of the company. They sometimes used banks for additional financing, but they were in close contact with their investments.

*Over time, these principal investors have increasingly used agents to act on their behalf.*

With the increasing “professionalisation” of investing over the past decades, specialised service providers in transacting, financing, monitoring, etc. have emerged. These agents were – at least in theory – aligned with the interests of their principals through performance incentives relating to the assets they selected and managed.

## Going back to roots

### Dr. Hanno Schmidt-Gothan of Perusa presents a case for new realities in principal investing

For example, they pooled the stakes of individuals in special purpose vehicles, called investment funds, and they received a management/transaction fee and a participation in the funds’ performance. And they could generate extraordinary returns: looking at historic figures from US and European funds, the top half of private equity funds were able to consistently generate IRRs of 18 percent and more.

*Eventually, “private equity” has developed into an industry much like other segments of investment banking.*

So far, so good. However, over the past 10 to 15 years the abundance of capital in search of attractive deployment sparked an extreme proliferation of “speciality investment opportunities” (country/regional funds, industry-specific funds, equity/debt/distressed debt funds, real estate, special situations/turnarounds, start-up, ...), each promising extraordinary returns for investors – and for their agents.

In addition, multiple levels of agents (e.g., funds of funds) re-packaged private equity investments into retail-size “opportunities”, and the lack of systematic regulation removed the principal investors

further from transparency and control over “their” investments.

Cheap money from banks and other sources fuelled this industrial model of private equity further, allowing multiple leverage layers of up to 100 percent of acquisition prices and leading to many low quality assets being traded at high prices of 10-plus times EBITDA. Thus, short-term fund performance was phenomenal in many cases, and – at least on the surface – had detached itself from the economic performance of the underlying assets. In many aspects, “private equity” became just another flavour of investment banking (note CDO/CDS fund performance until 2008).

**The dual crisis of 2008/2009 has thoroughly overturned the private equity business model.**

*The financial crisis has dried out the cheap money fuel for virtually all transactions.*

The main fuels for the industry were the availability of cheap money and relaxed controls. Lehman Brothers and the subsequent financial crisis changed everything: overnight, the supply of acquisition and operating finance dried

out and liquidity was at an extreme premium. Leverage became unavailable, challenging the transaction model of many buyout funds. Limited partners exercised pressure on GPs to minimise cash calls and some limited partners within the financial industry even became unreliable with respect to defaults.

*In addition, the ensuing economic crisis has led to substantial deterioration of portfolio performance.*

Even worse, the financial crisis and the subsequent economic crisis have threatened portfolio performance two-fold: the fundamental performance of investments (especially automotive and industrial, formerly the pets of the private equity industry) has nosedived, and re-financing of acquisition leverage has become virtually impossible. Covenant breaches and liquidity threats have catapulted portfolio firms and their investment vehicles into a downward spiral of declining performance.

Thus, if not having handed over control of investments to creditors altogether, many funds sit on “walking dead” portfolio firms – eating up cash, hard to restructure, impossible to sell without steep losses. Interestingly, according to a recent European exit study done by Ernst & Young, the number of private equity exits since the second half of 2008 has declined sharply, but the transaction multiples have not. Apparently, GPs would rather exit only a minimum of quality assets at near-historic prices that can attract requisite financing while continuing to sit on the rest rather than selling more at a discount. Is this rational economic behaviour, or are they simply trying to avoid bad news now, hoping for better times in the future?

*GPs with “non-standard” investors and terms are under pressure.*

Having played the leverage game to the utmost by leveraging their own GP commitment and trading classic institutional investors for retail investors (which accepted higher carry and management fees for the GP in exchange

for a higher hurdle rate), several GPs may be faced with severe consequences for their own economics.

So how can the industry recover and generate extraordinary returns once again?

**Given the vast variety of situations and terms, there is no simple answer, but we see some general trends for a fresh start back to the roots, which we have summarised in three basic hypotheses:**

*1. Financial engineering “value creation” may be misleading and cannot compensate for poor operational portfolio performance – GPs need a broader set of skills.*

Optimising the financial structure of assets has its value, but (de)-leveraging an investment as the main source of value creation has limited impact. When financial instruments, i.e. cheap money, are available abundantly, portfolio managers may benefit from pure financial engineering, clouding underlying performance issues. In tight financial markets, however, it's better to hold onto what you've got and focus on operational financing.

Multiple arbitrage and the “greater fool” paradigm only work in boom markets. Exit studies have shown that between 1990 and 1995 and again between 2000 and 2007, the exploitation of leverage effects and entry/exit multiple arbitrage accounted for up to 70 percent of value creation. In capital market downturns and slowly over time, operational (EBIT) improvements have steadily increased in importance.

Optimising economic performance through cost reduction, systematic growth programmes and alignment of (longer-term) incentives is a wise move: not only does it improve the EBIT and its quality, but also the valuation multiple applied on these EBIT figures.

Thus, funds need to be able to support their investments actively (looking at EBIT and cash flow once a month simply is not enough). This may also require some interim financing and additional equity. Furthermore, portfolio managers need

and at short notice through co-investments from the fund's limited partners. This allows for investments of up to €300 million enterprise value.

We are located in the centre of Munich and work in a pragmatic and expedient manner with no committees in either London or New York. Contact with portfolio companies is therefore often much more personable and intensive than with competitors.

With a term of up to 14 years, the fund we advise ranks among the longest-term investors in the market. As entrepreneurs, we also always invest our own capital and, as such, are actively involved in our projects.

## About Perusa

Perusa is a group of personally, professionally, and financially independent entrepreneurs. The fund we advise is not listed on any stock exchange and can act independently without worrying about quarterly reports and analysts. Its globally diversified group of institutional investors includes renowned international pension funds, banking and investment funds. As such, it is able to execute small investments and large transactions alike.

The fund advised by Perusa has access to over €150 million of equity capital, which can be increased anytime



# The expertise for a special situation

The right partner for private equity **should** do more than financial engineering. The fund advised by Perusa **can**.

## We are your reliable partner for:

- >>> Expansion
- >>> Crisis and turn-around
- >>> Management succession
- >>> Growth through acquisition
- >>> Spin-off

## >>> Our Claim

true economic improvement of our portfolio companies and a transparent partnership with our investors

## >>> Our Skills

active support of our investments – a broad set of commercial and operational skills are the key for their optimal growth

Find more about us at [www.perusa.de](http://www.perusa.de) or contact us directly:

### Perusa GmbH

Theatinerstrasse 40  
D-80333 Munich  
Germany

Phone: +49 (89) 2 38 87 89-0  
Fax: +49 (89) 2 38 87 89-50  
E-Mail: [info@perusa.de](mailto:info@perusa.de)

 PERUSA

to be able to cope with restructuring challenges, requiring deep commercial and operational understanding on the side of the GPs. Alongside transaction and financing resources, a layer of “operating directors”, able to act as chief restructuring officers with special expertise across portfolio companies - but also understanding the thinking of the GP – could be helpful.

Consequently, the ability and resource to actively engage at the fund level determines and limits the number and size of portfolio companies for an efficient fund – instead of becoming ever bigger and more complex. The ratio of GP staff per number/size of portfolio companies needs to increase.

*2. A stronger alignment of principals' and agents' interests and a more transparent investment structure are needed to achieve above-market average returns.*

Over the past decades, GPs have been spoiled by success and have become ever more demanding, while disaligning themselves from their principals. Fundraising sizes exploded (bigger is better), GPs went public to capitalise on future carry/management fees, fund terms went up to 30 percent carry and 3-plus percent management fees. Persuaded by extraordinary returns, principals put pressure on the LPs as their agents to invest. A new modesty in terms and the realisation on both sides that private equity no longer guarantees an easy profit – but

that extraordinary returns require close alignment and true partnership – needs to become the paradigm of the industry.

Furthermore, transparency is the key for a true partnership between general and limited partners. As avoidance of bad news is part of human nature, how many GPs are not completely open with their LPs? Increasingly, LPs demand interim information on portfolio companies including valuations and compliance reports. Eventually, not being open with LPs will backfire on fund managers.

*3. The classic institutional fund model with a high degree of operational involvement (re-) emerges as the superior approach due to lower risk, true economic improvement of underlying assets and lean cost structure.*

On the LP side, transparent standard terms with a long-term incentive structure and a few solid institutional investors seems superior to complex structures, multiple layers of leverage, retail investors etc., since a mutual trust-based relationship with a few blue-chip investors helps more in tough times than defaulting/defecting LPs. While principal investing is mainly about money rather than philanthropy and loyalty, sticking together in tough times – rather than pure optimisation of one's own interests – can generate a win-win situation with, at least in the long run, superior performance for principals and their agents. ■