

The private equity boom was a clumsy trick

Michael Gordon

So now we know. The boom in private equity, which was promoted as the superior business model, based on patient capital, superior management and an alignment of interests, was nothing more than a trick of financial engineering – and a clumsy one at that. The magic of leverage works both ways, as we are discovering.

Henry Kravis of Kohlberg Kravis Roberts is asking his investors to be patient after a bout of negative returns and writedowns, echoing the cries of Alan Bond and other entrepreneurs of earlier credit cycles. Hamilton James, Blackstone's president, said at the Super Returns private equity conference on February 26: "We're a proxy for the credit markets." David Rubenstein, co-founder of Carlyle Group, recently asked whether "modest return" was a more apt name for private equity. He thinks it's funny. It's not.

As investors are increasingly bruised by the recognition that reality has once again triumphed over hope, the private equity barons are having to confess that the benefits of superior management, alignment of interest and, of course, the superior reward structure counted for very little.

Many of the private equity deals look no different from Yell and other highly leveraged public companies. As Warren Buffett notes, when the tide is going out, we find out who has been swimming without their shorts.

Sometimes a simple observation can prove an important point. In November 2006 Citibank published a research report that highlighted how private equity returns could be achieved by just leveraging basic stock market indices. It is a seminal note. "How do they do that?" asked the report, and then went on to provide the answer.

By leveraging the basic stock market

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indices by three to one, Citibank pointed out, returns could exceed even the best historical private equity returns. Never mind that as they were spellchecking the final version of the note, leverage on that season's deals was reaching four to one and even five or six to one.

As Citibank pointed out, the private equity barons would always emphasise alpha over beta – their ability to outperform a market rather than merely ride the market wave – but it showed clearly that leveraged beta was where the returns were being generated.

Interestingly, a similar lesson could be being learnt in other asset classes.

Shaken but not stirred, the private equity barons are looking to move on. Dismayed and disillusioned western investors will not play ball. In the leveraged loan markets, assets have been marked down by a fifth, so 80 cents in the dollar is the new par. Thus the financial alchemists have turned to the huge pools of money available in the Middle East and Asia.

Guy Hands of Terra Firma believes they will enable the disintermediation of Wall Street and the City of London. Perhaps, but in what shape and form?

Does he really assume that these new investors will be as naive as many of the investors in some of the five- and six-times-levered private equity deals of the past three years? I would be surprised. Commentators have suggested that many state-backed funds are still in their infancy and thus do not have the experience and organisation to cope with "big debt investments". That gives the private equity guys something of a problem.

Private equity as we have come to know it is all about debt – lock, stock and sinking barrel. There may have been better management and better incentive structures in the deals of recent years. But they really contribute nothing to the overall return when compared with the impact of the leverage in the capital structure.

So let us be candid. The deals of recent years are leveraged buy-outs. Let us give them their proper name. It is a shame that private equity has been degraded by misused financial engineering that was permitted by easy monetary policy and lax credit conditions. Moreover, the fact that these structures generated enormous management fees bears further questioning. These LBO deals and their business models were held up as superior in structure and therefore in worth. Massive fees were thus justified. That the market was happy to pay these for a simple leveraged structure that could have been assembled in a DIY fashion seems remarkable now.

In reality, private equity should not be about debt. Pure, properly capitalised private equity remains a wonderful business model. It should be able to prosper without recourse to cheap and easy finance.

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