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PRIVATE EQUITY AND IMPACTS ON RECENT FINANCIAL CRISIS

ÖZEL SERMAYE VE SON EKONOMİK KRİZE ETKİLERİ

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ABSTRACT

The private equity industry has grown markedly in the last twenty years and academic research has increasingly focused on the effects of private equity. Private equity is capital that is not noted on a public exchange. Private equity is composed of funds and investors that directly invest in private companies, or that engage in buyouts of public companies, resulting in the delisting of public equity. There has been a lot of research carried out on private equity hence this not being the earliest or will be the latest. Some researchers focus on perspectives of the limited partners (LPs) and some focus on the company level whiles comparing returns (Thorkilgaard, 2012).

The aim of this essay is to introduce private equity, analyse the extent to which private equity has fallen victim to the recent credit crunch and to bring out underlying issues in hedge funds and private equity. Lastly is to speculate the future effects of this turmoil.

Key Words: Private Equity, Hedge Funds, Financial Crisis, Credit Crunch

ABSTRACT

Özel sermaye endüstrisi son yirmi yılda belirgin bir artış gösterdi ve akademik araştırmalar giderek özel sermayenin etkileri üzerine yoğunlaştı. Özel sermaye, bir kamu mübadelesinde belirtilmeyen sermayendir. Özel sermaye, doğrudan özel şirketlere yatırım yapan veya halka açık şirketlerin satın alınmasına katılan fonlar ve yatırımcılar arasından oluşur ve kamu sermayesinin feshine neden olur. Özel sermayeyle ilgili çok sayida araştırmalar yapılmıştır, Bazı araştırmacılar, sınırlı ortakların bakış açısına (LP) odaklanırken, bazıları geri dönüşleri karşılaştıran şirket düzeyinde odaklanırlar (Thorkilgaard, 2012).

Bu çalişmanın amacı, özel sermayeyi tanıtmak, özel sermayenin son kredi sıkışıklığına ne ölçüde düştüğünü analiz etmek ve hedge fonlar ile özel sermayedeki temel sorunları ortaya çıkarmaktır. Son olarak, bu kargaşanın gelecekteki etkilerini spekülе etmek.

Anahtar Kelimeler: Özel Sermaye, Hedge Funds, Finansal Kriz, Kredi Krizi

WHAT IS THE PRIVATE EQUITY

Private Equity (PE) to an extent refers to funds used to buy a public company that is at the verge of loosing its stand in the stock market. This is a private ownership that involves the investment of money by lenders or institutional bodies into a private or public company. Most private companies emerge from the public listed companies as a result of them dying out slowly from the market. In these regard, individual(s) or private equity investors come in to revive or make these existing companies better in terms of capital structure and performance (Thorkilgaard, 2012 and Amadeo, 2013). According to Hagendoorn (2007) "Private equity is an equity investment in a company not listed on a stock market".

Private equity as described by Seretakis (2013) consists of development capital, mezzanine capital, Leveraged Buyouts (LBOs), venture capital and distressed investing. In recent times the LBOs have taken keen in the private equity environment were it uses much amount of debt than in equity to acquire an already existing business. In an instance where LBO in a public company is virtually or totally delisted from the stock exchange and it's acquired is termed public-to-private equity.

Financing is done by initial capital loans from banks and borrowings from investors which are placed in an investment fund (Thornton, 2007). These investors are also known as limited partners who contribute a percentage of capital as an investment into the fund with high expectation of making returns as this investment is but for a short period. This is evidenced in a Danish private equity which has barely owns 10-15 companies that operates with 10years a particular issue (Thorkilgaard, 2012). The private investors become involved in a company when the become part of board and are part of restructuring management (Wood and Wright, 2009).

Many leveraged buyouts are swallowed up by specialized investment firms by using a low percentage of equity and a high percentage of debt in financing. These leveraged buyouts (LBOs) are what we term as private equity firms. Some scholars or studies have a conflated view of private equity firms and venture capital firms when they by no means similar because of their distinct nature. Whiles the latter part concentrates on investing into young (up-coming) or emerging companies, the former is into investing in already existing companies (Wood and Wright, 2009).

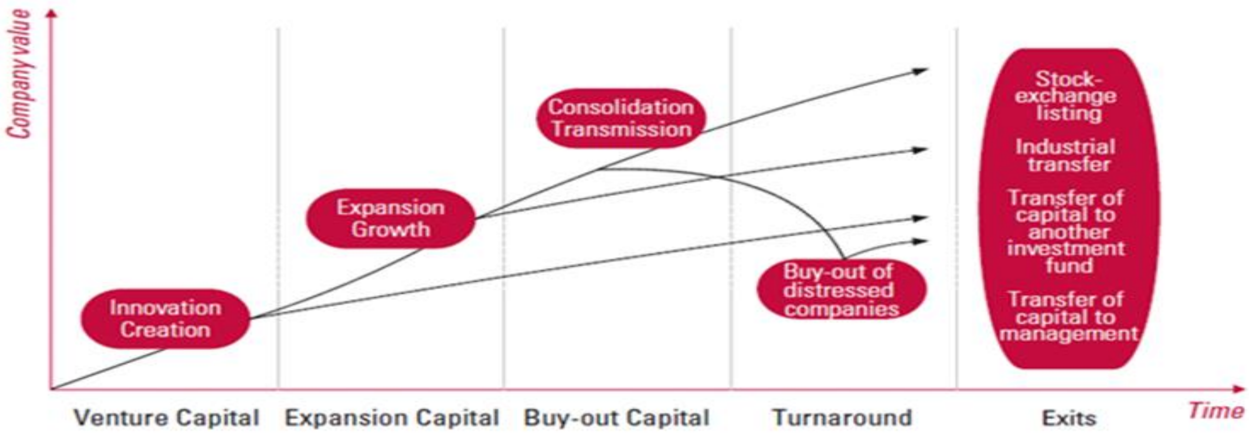
The deals in here are seen from two dimensions; management buy-in (MBI) that involves existing management raising funds to buy a public company into private and the management buy-out (MBO) that requires outsiders to take-over the company into private.

Figure 1.
World's 9 biggest private equity funds

1.	Goldman Sachs Merchant Banking Division's Capital Partners VI	$20.3B
2.	TPG Partners VI	$18.9B
3.	Apollo Global Management's Investment Fund VIII	$18.4B
4.	Apax Partners' Europe VII	€11.2B
5.	KKR's Fund 2006	$17.6B
6.	Blackstone's Capital Partners VI	$16.2B
7.	TPG's Partners V	$15.4B
8.	Apollo's Investment Fund VII	$14.6B
9.	CVC Capital's European Equity Partners V	€10.8B

Source: Forbes, 2014
(See Appendix)

Figure 1.
Private Equity and Companies' Life Cycles



(Source: Caceis, 2010)

In the above graph the early stages on venture capital increased since capital is available with new methods and ideas which has attracted new customers.

Private Euity and Hedge Funds

The hedge funds enables prediction in market of any uncertainty in the future and this has made it acceptable to be a risk reduction factor although it is not registered with the Securities and Exchange Commission (SEC) (United States Department of Labor, 2011).

Private equity and hedge funds with their distinct features are often perceived to be similar in their investment perspectives. Considering hedge and private equity funds to be identical to some extent will lead to greater competition and higher acquisition prices which will negatively affect returns in the future. The former invest mainly into illiquid assets whiles gaining management control whereas the latter is into liquid assets with less or no management control gained. In the event of company deteriorating, public funds are of disadvantaged than the hedge funds in that investors in hedge funds can refrain from the market where as private equity money are "locked up".

In the wake of the crisis, hedge funds took over the lending role from banks since many acquisitions by the private equity firms were sourced by them (Singh, 2008).

The Difference Between Private Equity and Hedge Funds

Hedge funds and private equity play important roles in the life of the financial sector despite their distinct features in their classes as assets (Achleitner and Kaserer, 2005). They do have different forms of operations in terms of their investment plans, structures, fund terms among others even though they share some similarity under federal security laws (Bevilacqua, 2007).

Below are their differences;

Values

Private equity concentrates on value creation in the long-term and will continue to increase shareholder's wealth due to their flexibility and ability to study trends. In contrast, the hedge fund that bases its idea on finding value for an investment strategy that is short-term.

Securities

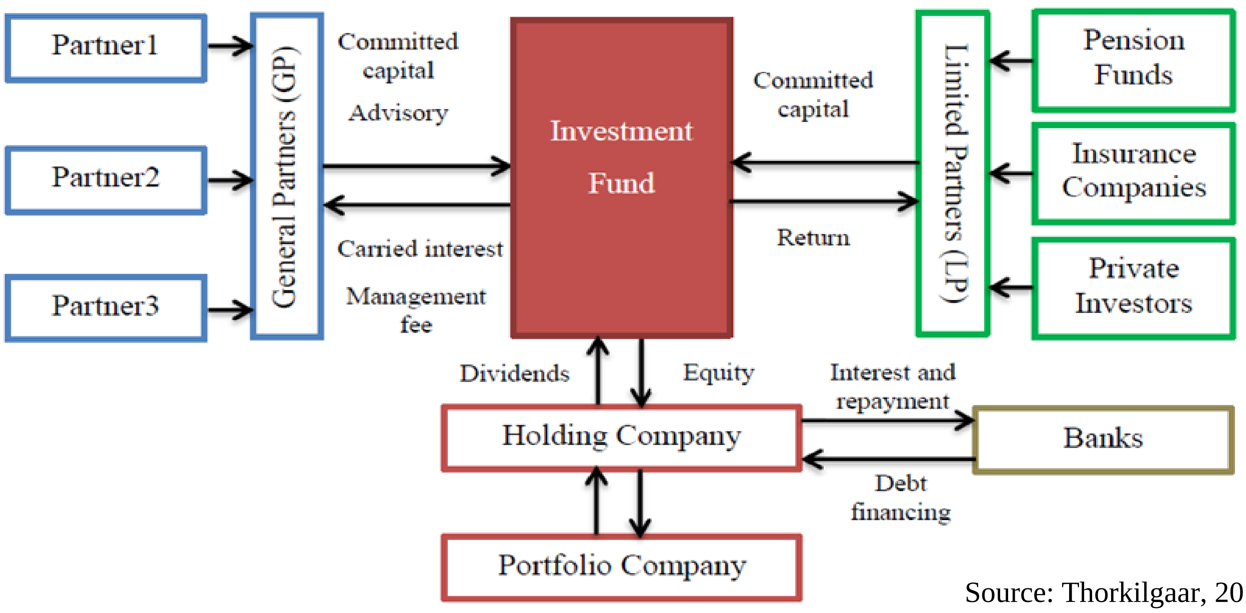
Private equity firms focuses on illiquid securities whiles hedge funds dealings is in trading securities that are short-term based. Recently, there has been a shift in hedge funds where they are moving into the long-term investment of public companies and gradually taking interest in the corporate governance.

How Private Equity Works

The Private Equity was formally known as bail-out and it was the simple kind of asset classification. It is a fund that keeps record of management inlays and outlays and has the confidence of growth in the future. They do have lot strategies to increase the company's performance and to make them stand out of others among other competitors. In this company every investor work for the achievement of one particular goal not forgetting the risk associated with it (Investing Questions Answered, 2014). However, there are some responsibilities associated with the private equity which are sourcing, transactions, completing investment, success of portfolio companies and exiting the investor (Stein, 2007).

Figure 3.

Private Equity Business Model

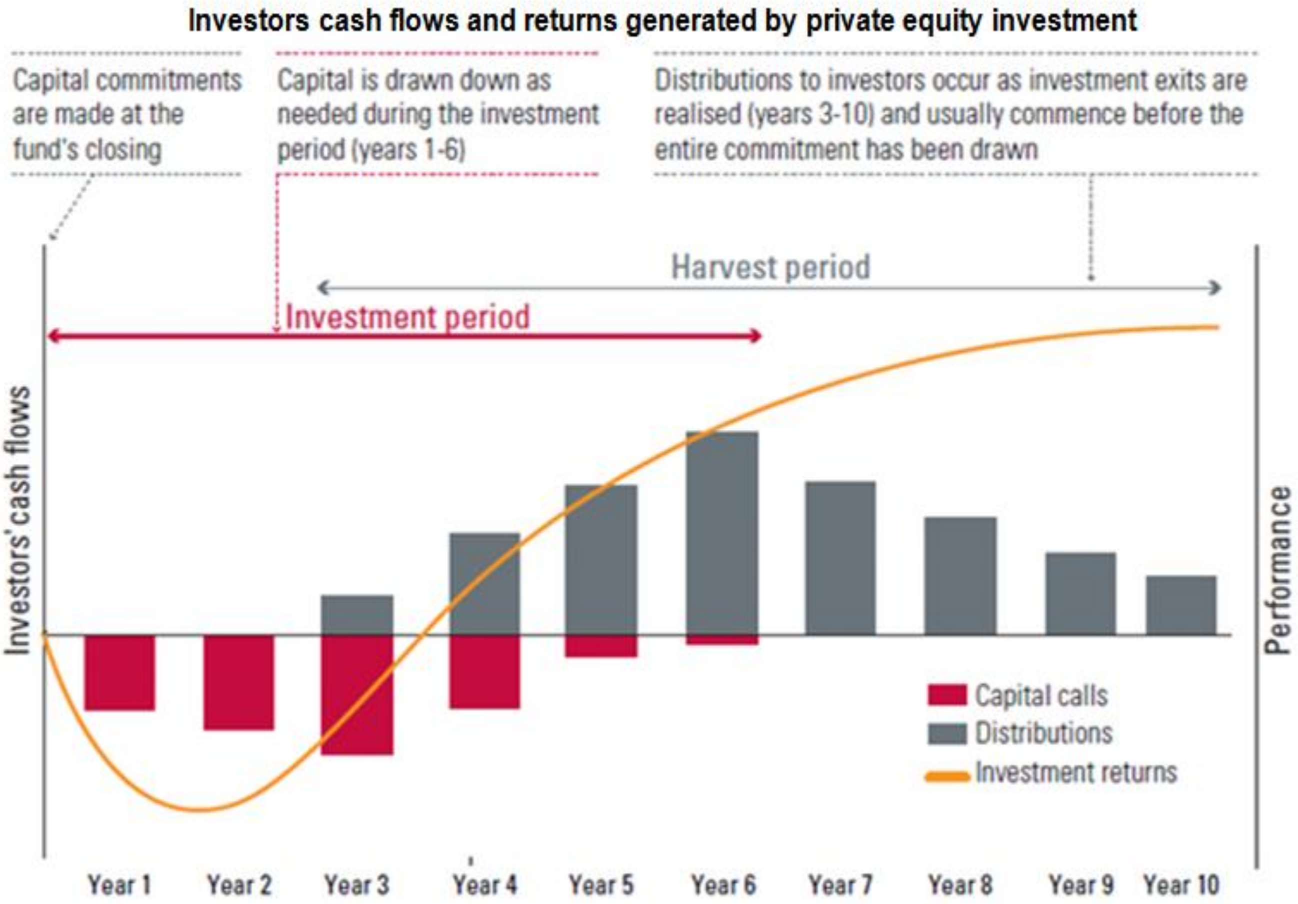


Source: Thorkilgaar, 2012

The figure 3 above shows a lot of parties involved in the investment fund of private equity.

Capital is raised by private equity firm through two main sources thus by internal partners (general partners) and external partners (limited partners).These limited partners contribute a percentage of capital as an investment which are added to the main capital providers and they placed in an investment fund. In private equity firms the business operational activities are but for a limited period or on short-term say between three to seven years(3-7 years) and this makes parties very complex in their dealings as they do not risk their investment for nothing (Thorkilgaard,2012).

Figure 4.



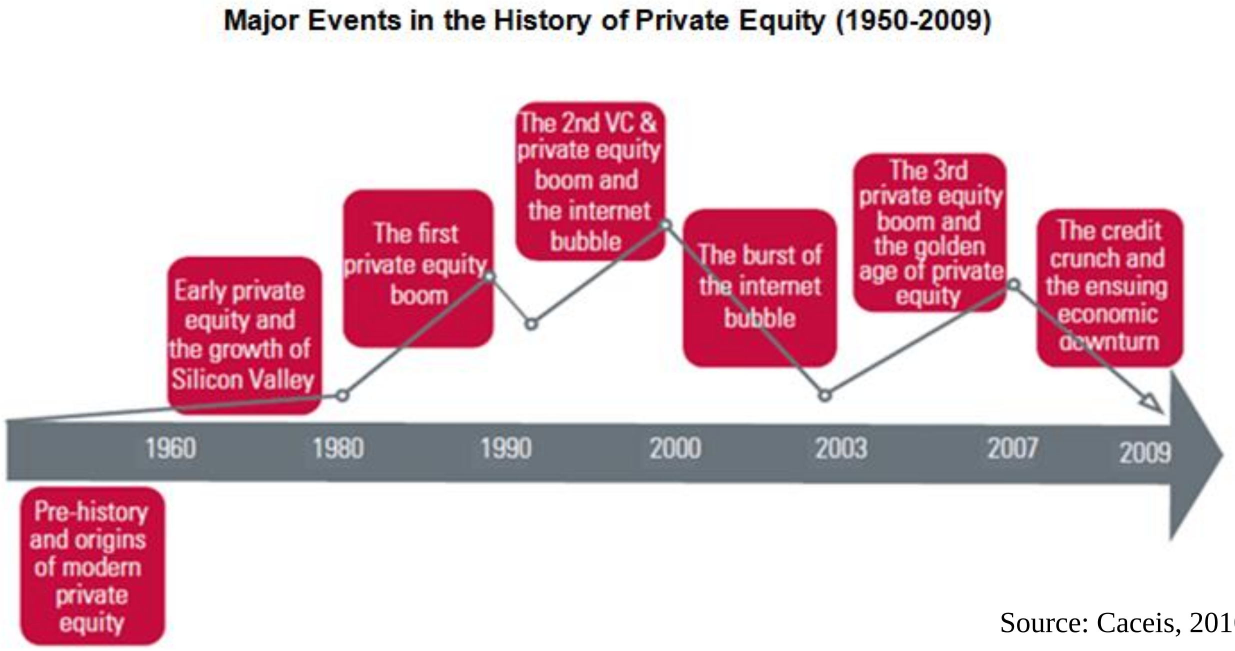
Source: Caceis, 2010

In the above graph, return is matched with value. This lower return is attributed to management fees and the gain is from the additional value derived by investee companies. The relationship existing between return and value on funds is termed as “J-curve effect” since its in a shape of the letter “J” (Caceis Investor Services, 2010).

History of Private Equity

Private equity as a small class of asset has recently seen a tremendous growth globally. Traditionally, private equity emerged from the U.S until it gradually moved into Europe and who knows what might become of it in the near future; an aspect that will be answered in the latter part of this study. Many think that the European’s strict legislation will actually have a negative effect on the private equity by gradually “dragging it out into the mud” but this turned out to be the opposite since it was similar levels with the US. This has been stated in the Fordman Journal of Corporate and Financial Law in which between years 2000-2004 Western Europe has surpassed the U.S in buyout activity. This represents the most active European equity in terms of value transaction and volume as the majority of European and U.S private equity are operated in Europe since its headquartered there. The European private equity has and will continue to grow due to single market development, increasing European capital market, financialization of Europe and moving forward towards the Anglo-Saxon capitalist model (Seretakis, 2013).

Figüre 5



Source: Caceis, 2010

Source Criticisim

There is biasedness in knowing the story behind the private equity since most of these individuals are co-owners and experts, marketing their business to make it sound or look good like" icy on a cake". This not with standing, we think that other sources of information will help to come out with objective views on how private equity will become of in the near future (Thorkilgaard, 2012).

The Credit Crunch and Private Equity

According to Caceis (2010), Journal the economic downturn in the between the year of 2007-2009 had swift from the mortgage effect into the LBOs and high yield markets. This was evidenced in the month of September when these major lenders; Citigroup and UBS AG recorded a significant decrease in their turn-out. Private equity were eventually in a bust cycle as they barely had enough leverage in acquiring companies and fund raisers were not dependable because of the credit crunch situation.

What Impact has the Credit Crunch Had on Private Equity

Private equity through six economic downturns since 1978 has survived the market due it flexible industry nature. Banks with its large lending base reduced during the credit crunch season as a result of capital shortage. A report on "private equity portfolio company performance through the recession" states that in the recent crisis efficiency and profitability was at its high pace as compared to private firms. This goes further to explain why private equity is flexible to the economic conditions (BVCA, 2014). In the case of losses, not many will sympathise with the private equity players. The reason is the investment with huge debts and job cuts must pay off the benefit thereof through remunerations. Leaving this private equity to their fate in the case of failure might not be the best. Government must intervene to safeguard them from any developing financial crisis because of the high debt that they employ as their source of funding. This could be done through a dilution of debt –for-equity swaps or government stakes which might not be the best method but better way of dealings (Ishikawa, 2009).

Has Private Equity Suffered From the Recent Financial Crisis

Private equity among other companies fell prey to the financial crisis in 2007. Some have questioned its continued existence whether now or later in the future (Primack, 2013). What termed to be good or bad loans were less of a concern by banks and other financial institutions since others were readily available to embrace such offers (Amadeo, 2013). An evidence of this is that loans made by these banks to private equity funds were based on Collaterized Debt Obligations (CDOs) which was not the case in earlier years. Also, share prices were up since private equity financing allowed the buy-back principle by corporations during the financial turmoil (Private Equity Spotlight, 2007). Amadeo (2013) concludes that one of the factors that led to the 2007 banking liquidity crisis was the excess liquidity created by the private equity.

Golden Age

What turned out to be the forces that led into a buyout in U.S subprime mortgage movement from 2003-2007 was no different during the financial crisis in 2007/2009. Loan market from an institutional perspective turned out to a capital market to expand the debt capacity available to Leveraged Buy-Outs (LBOs). In this regard, private equity ceased investing in companies and chose to invest in capital markets; thereby making them perform in funding activities rather than investing activities. However, deal flow stopped and recapitalization fell when private equity firms no longer obtained funding during the summer (2007) of subprime crisis. This continued through from 2008/2009, yet market stabilization was at a low level. This is evidenced in losses of 30%-40% at Carlyle, KKR, and Blackstone just to mention a few (Rizzi, 2009).

Future Speculation

The International Journal of Management Reviews notes that private equity is a very diverse topic and many do embrace the fact that the firms of LBOs act similarly when they are actually not. The reason is buy-ins and LBOs management are less preferred to MBO by the employees. Conclusions on which form of private equity is either ‘good’ or ‘bad’ can be reached when an in-depth analysis is undertaken or carried out to know the differences (Senequier, 2010).

Conclusion

Private Equity has attracted policy makers to recognize its importance in the financial marketplace. This however has established a universal approach with dealings in public market and corporate ownership. The question that is begets is whether the world will meet opportunities and redirect their focus on smaller middle market target size (Radke, 2013).

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Appendix

Private Equity Firms are below

Generalist Funds with London-based operations

The Carlyle Group (www.carlyle.com)

KKR (www.kkr.com)

The Blackstone Group (www.blackstone.com)

TPG Capital (www.tpg.com)

Permira (www.permira.com)

Apax Partners (www.Apax.com)

Bain Capital (www.baincapital.com)

CVC Capital Partners (www.cvc.com)

Cinven (www.cinven.com)

Apollo Management (www.agm.com)

3i (www.3i.com)

Warburg Pincus (www.warburgpincus.com)

Terra Firma (www.terrafirma.com)

Hellman & Friedman (www.hf.com)

General Atlantic (www.generalatlantic.com)

Charterhouse Capital Partners (www.charterhouse.co.uk)

Sun Capital Partners (www.SunCapPart.com)

BC Partners (www.bcpartners.com)

Bridgepoint Capital (www.bridgepoint.eu)

Doughty Hanson & Co (www.doughtyhanson.com)

Pamplona Capital Partners (www.pamplonafunds.com)

Elecktra Partners (www.electrapartners.com)

Inflexion Private Equity (www.inflexion.com)

TA Associates (www.ta.com)

Advent International (www.adventinternational.com)

Clayton, Dubillier & Rice (www.cdr-inc.com)

Barclays Private Equity (www.bpe.com)

Duke Street Capital (www.dukestreet.com)

Eurazeo (www.eurazeo.com)

GI Partners (www.gipartners.com)

HIG Capital Europe (www.higeurope.com)

IK Investment Partners (www.ikinvest.com)

Phoenix Equity Partners (www.phoenix-equity.com)

Rhone Group (www.rhonegroup.com)

Silverfleet Capital Partners (www.silverfleetcapital.com)

Hg Capital (www.hgcapital.com)

PAI Partners (www.paipartners.com)

Cerberus Capital (www.cerberuscapital.com)

Star Capital (www.star-capital.com)

Montagu Private Equity (www.montagu.com)

Omers Private Equity (www.omerspe.com)

Arle Capital (www.arle.com)

Vista Equity Partners (www.vistaequitypartners.com)

Capvest (www.capvest.co.uk)

Pamplona Capital Partners (www.pamplonafunds.com)

Sector Specialists

TMT, Growth Equity

Providence Equity Partners (www.provequity.com)

Silver Lake Partners (www.silverlake.com)

Summit Partners (www.summitpartners.com)

GMT Communications (www.gmtpartners.com)

The Gores Group (www.gores.com)

Quadrangle (www.quadranglegroup.com) - Media

Veronis Suhler Stevenson (www.vss.com) - Media

Consumer Goods

Lion Capital (www.lioncapital.com)

Neo Capital (www.neo-cap.com)

Financial Services

J.C. Flowers (www.jcfco.com)

Corsair Capital (www.corsair-capital.com)

JRJ Group (www.jrjgroup.com)

Anacap (www.anacapfp.com)

Infrastructure

Borealis (www.borealis.ca)

Global Infrastructure Partners (www.global-infra.com)

Clean Technologies / Environment

Climate Change Capital (www.climatechangecapital.com)