OnPoint

Dechert LLP

Private Equity Newsletter

Fall/Winter 2012 Edition

Private Equity Grows Up

by Kenneth E. Young

Are the days of the traditional private equity firm over? Over the past several years my colleagues and I have helped some of the largest private equity firms transition into more broad-based asset managers. This transformation is occurring in a myriad of forms. Many of the biggest private equity shops are diversifying their platforms by offering new, complementary products, such as closed-end funds, Business Development Companies (BDCs), and hedge funds. At the same time, fixed-income firms are diversifying into private equity. This trend is being driven by several factors and presents both challenges and opportunities for dealmakers.

The End of the “Private” in Private Equity

The “private” in private equity is eroding. For most private equity firms the SEC registration deadline has passed. Private equity firms (and LPs) have already begun reporting performance and other data that used to be considered proprietary, and the registration process will only increase disclosure. The implementation of the Volker Rule will also provide firms with the opportunity to acquire expertise from the larger banks over the coming years. Many firms have created internal legal, compliance and accounting capabilities that didn’t exist in the “early” days of the industry. Firms have expanded their focus beyond balance sheet optimization to value creation – often employing industry experts or creating their own in-house consulting firms. This infrastructure adds expertise but comes at a cost. New products offer a way to grow and diversify a firm’s funding sources and revenues while also expanding a firm’s brand.

Capital Structure Expertise

The private equity industry has grown tremendously over the last 30 years. In 1981, there were 23 private equity firms. In 2011 there were over 4000. In the last ten years alone, private equity assets under management have grown from approximately $750 billion in December of 2001 to almost $3 trillion in December of 2011. As the firms have expanded, so has their expertise with all layers of the capital structure, not just equity. This expertise, originally developed to obtain the best execution for buyouts and portfolio companies, creates the opportunity to offer new products and extend a firm’s “brand” into new areas. Because the expertise and infrastructure exists, firms are able to offer new products to their existing investors to meet investors’ allocation demands, rather than drive investors to different firms to access other asset classes.

Expanding the Investor Base

Private equity firms that are expanding their offerings are able to decrease their reliance on the traditional LP community as they draw on a more diverse funding base. At one end of the spectrum, some of the larger private equity shops have gone public. This provides one type of permanent capital, a balance sheet, and also provides a way to monetize founders' stakes and help with succession planning. However, it can also increase the interest in offering additional products because markets want to see consistent revenue and stable, long-term financing sources. To diversify investors and funding, firms are offering more regulated permanent capital-type products, including BDCs and closed-end funds. As firms offer these new registered products they have to become more comfortable acting within the purview of the Investment Company Act of 1940, and in doing so, they can begin to think about offering products to the mass affluent investor and retail investor classes. Just as sovereign wealth funds provided a source of new capital when U.S.-based institutional LPs had allocation challenges following the credit crisis, the mass affluent and retail markets provide an enormous investor base to whom growing firms can market themselves.

As happens to all new industries, the private equity business in many ways has matured but that does not mean it has ceased to evolve. Increased regulation, transparency and growing expertise are pushing many traditional private equity firms towards becoming more full-fledged asset managers, and this shift will surface complexities and operational challenges, as well as new opportunities. It should be an exciting evolution for all involved.

****

This article originally appeared in The Deal.

Kenneth E. Young
Philadelphia/
New York
Send an email
T: +1 215 994 2988/
+1 212 698 3854

Click here to return to table of contents.