Private Equity Industry: Southwest Firms Draw on Regional Expertise

By Alex Musatov and Kenneth J. Robinson

The private equity industry runs the gamut from small venture-capital investments in startup companies to multibillion-dollar buyouts of well-known public corporations.

Neiman Marcus, Harrah's, Petco, J. Crew—these well-known names are among the holdings of companies owned or co-owned by private equity (PE) firms in the Federal Reserve's Eleventh District. The region is home to more than 175 PE firms, including the world's third-largest, Fort Worth-based TPG Capital.[1] Together, these entities have raised more than $109 billion over the past 10 years and sit on $31 billion pending investment.[2]

While the PE business model goes back to the times of early seafaring enterprises funded by limited private partners, its modern U.S. iteration dates back to the 1950s and the first venture capital funds. More recently, the industry and its sometimes opaque operations have come under increased regulatory scrutiny amid concern about their riskiness and systemic importance to the financial system. Although detailed data are hard to come by, regionally based PE firms are distinguished from their counterparts nationwide by the sectors they favor.

What 'Private Equity' Means

The term "private equity" is used very broadly—often inconsistently—because it encompasses a vast range of strategies for investing in companies whose shares are not publicly traded. In its simplest form, a PE firm consists of a team of professional investors who declare their intent to raise a fund of specified size with an expressed investment strategy. The team solicits accredited investors—primarily institutional money managers and high-net-worth individuals—to raise the targeted amount.

Once a fund is closed to additional investors, the firm deploys its capital through a series of acquisitions, generally occurring over a period of up to three years. The next five years or so are spent managing, advising and improving the portfolio of companies.

The final stage of the private equity cycle—the exit stage—entails divestiture, with the acquired firms typically operationally stronger and more valuable, reflecting the PE sector's benefits to the economy. Exits can take the form of an initial public offering of shares or a sale to a corporate buyer or another PE firm. The full cycle often requires a 10- to 15-year commitment from investors, highlighting the long-term, generally illiquid characteristics of private equity financing.

Nonpublic Funding

The PE industry runs the gamut from small venture-capital investments in startup companies to multibillion-dollar buyouts of well-known public corporations. They all share a nonpublic funding structure under the leadership of a professional general partner who deploys capital raised from limited partners. The PE universe is most often segmented by the life-cycle stage of target companies—from startups to mature operations.

"Venture capital" firms invest almost exclusively in young companies, often before their first revenues materialize. Venture capitalists are often willing to lose their entire principal on most investments in order to hit a home run with one potentially revolutionary technology or business method that reaps enormous returns. The earlier the stage targeted, the higher the risks and the greater the potential rewards. In addition to capital, venture capital entities often provide technical know-how and industry expertise to their portfolio firms. Google, Microsoft and Apple are some of the most illustrious venture capital success stories.

"Growth equity" and "mezzanine debt" funds target companies in later stages than venture capital. These PE participants provide capital—either equity or debt—to young but stable businesses that require bridge financing between venture capital and public financing.[3] PE firms in this particular segment hope to capitalize on rapid growth and typically exit the investment once the firm can access bank loans or public equity markets. Mezzanine debt refers to cases when a PE fund opts to lend to, rather than provide equity in, a growing firm. The loans typically have very flexible terms but rank below senior debt in the event the company defaults. For this added risk, mezzanine funding comes with relatively high interest rates.

The "leveraged buyout," or LBO, is by far the largest and most recognized private equity strategy. Many think of PE and LBO as synonymous. LBOs are often involved in the acquisition of famous brands, combining equity with large amounts of borrowing to employ significant leverage and gain control of target companies.

Debt is a key component of this business model because the leverage employed can amplify the returns generated by an initial equity investment. Buyout firms target companies that have strong, predictable cash flows since those will be needed to repay large borrowings. This makes the buyout segment highly dependent on the debt markets for financing. The banking industry plays a key role in LBOs. As of June 30, U.S. banks reported $115.4 billion in leveraged loans and securities on their books.

In addition to these primary styles, PE firms pursue various specialized investment strategies. This "other" group includes firms that invest exclusively in financially distressed businesses and companies on the brink of bankruptcy (or already in bankruptcy proceedings) and PE firms that invest in other PE firms, so-called secondaries.

Funds committed to LBOs account for the largest relative amount of PE capital available for investment in each of the major strategies (*Chart 1*).

Within each segment, PE firms specialize primarily by industry and size of target firm. With the exception of the largest PE firms, which tend to diversify across industries, fund managers prefer to acquire firms within very specific subsegments, often leveraging one portfolio firm to help another one grow or even merging related business into a single entity. Narrow industry specialization has been shown to produce higher returns, and industry participants—including potential acquisition targets—prefer PE firms with deep experience in a particular sector.[4]

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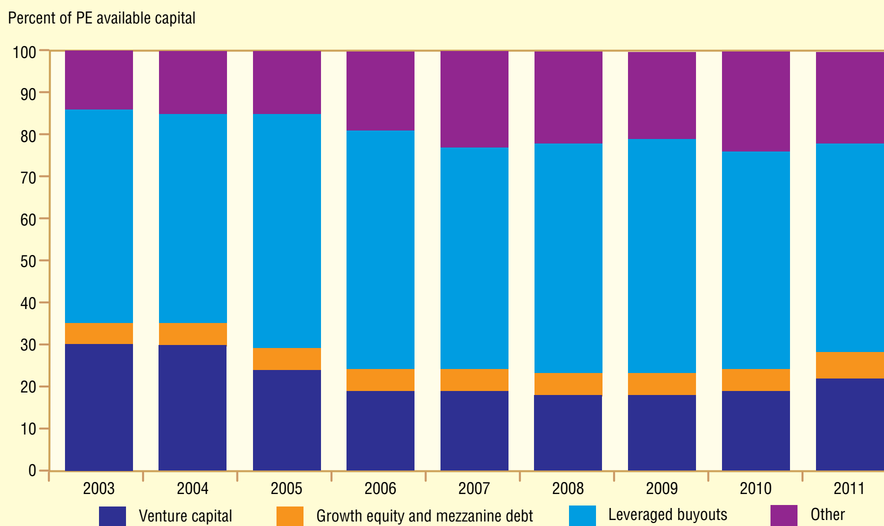
Surviving the Financial Crisis

The PE industry has largely recovered from the recent global economic turmoil,

Chart 1
Leveraged Buyouts Are Largest Share of Private Equity Available Capital



NOTES: "Available capital" refers to capital not yet invested at year-end. 2011 data are through second quarter.

SOURCE: Preqin.

reflecting the long-term nature of its model, with investors committing funds for 10 to 15 years and anticipating a lack of interim liquidity. The industry, therefore, tends to experience less instability than equity and fixed-income markets.[5] Still, with the onset of the financial crisis, PE capital declined steadily as the inflow of new investment funding slowed; capital peaked at almost $900 billion globally in 2008.[6]

The industry has also been placed under increased regulatory scrutiny. The Dodd–Frank Wall Street Reform and Consumer Protection Act, signed into law in July 2010, requires that PE and hedge funds as well as other private pools of capital with at least $150 million in assets under management register with the Securities and Exchange Commission.[7] The law also imposes new record-keeping and disclosure requirements that will give financial supervisors information to evaluate both individual firms and the state of the overall market, closing a regulatory gap that had existed in this sector of the financial marketplace.[8]

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The economic downturn and heightened investor risk aversion affected the industry's dynamics. A large portion of the capital attracted during the 2005–08 peak years remains dormant because of limited profitable investment opportunities. Although investors curbed some incremental commitments, and total funds raised contracted after 2008, PE firms couldn't spend the large cash positions they had already built up (*Chart 2*).

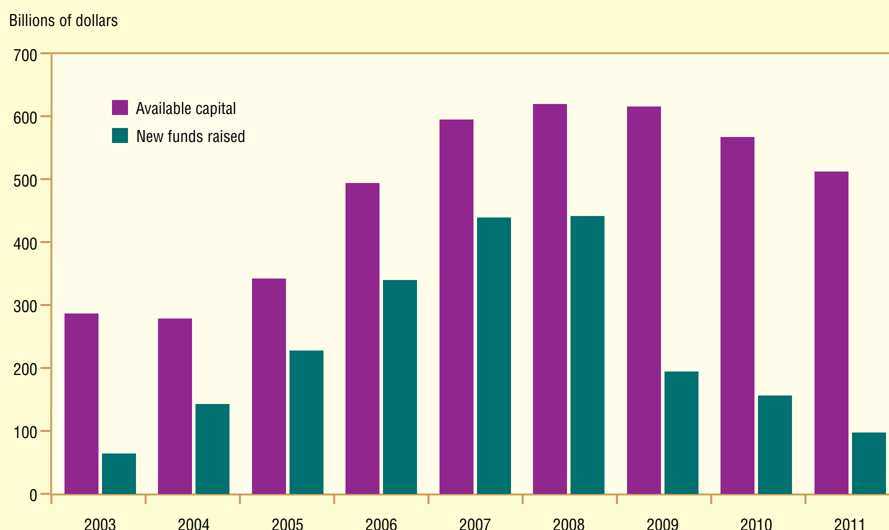
In response, some PE firms diversified outside of their standard business models, pursuing alternative investment strategies that include hedge funds and real estate funds. In addition, the relative health of corporate balance sheets has increased competition for purchase targets. Corporations now periodically outbid PE firms in auctions for business acquisitions.[9]

Southwest Private Equity

While PE is global in most respects—U.S. investment interests can raise money from a European pension fund and invest it in Asia—individual firms tend to cluster near hubs of their target industries. Proximity allows fund managers to build industry relationships, identify potential targets and manage a company more actively after its acquisition. Also, PE firms prefer to hire insider experts directly from their target industries—and expert staff is often reluctant to relocate.

Proximity can be especially important for venture capital firms, which must often identify promising investments even before a formal company exists. Out of 29 PE firms in Austin, for example, 19 focus on high-tech venture capital. Largely due to the presence of prominent high-tech companies such as Dell and a large university population, Austin is home to almost one-third of all venture capital firms in Texas.

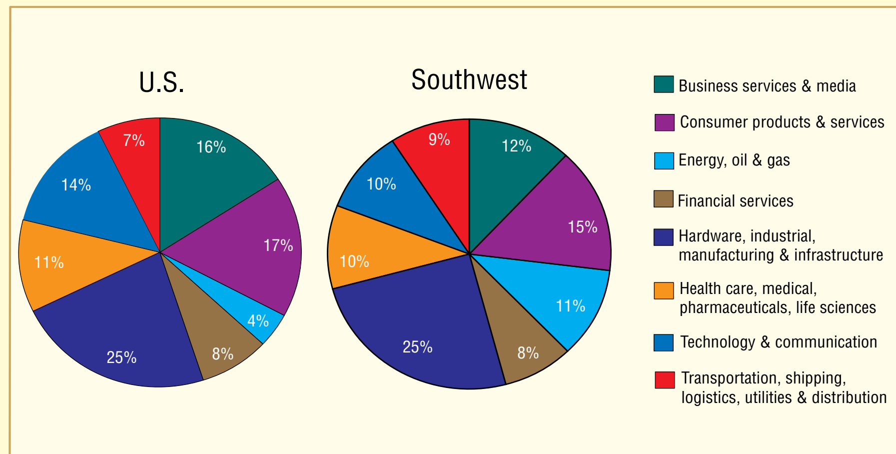
Chart 2
Ready Capital in U.S. Remains High Despite Decreased Fundraising



NOTES: "Available capital" refers to capital not yet invested at year-end. 2011 data are through second quarter.

SOURCE: Preqin.

Chart 3
Private Equity Transactions Differ in Southwest Region
(January 2005 to July 2011)



NOTE: Percentages may not add to 100 due to rounding.

SOURCE: Prequin.

Not surprisingly, Southwest-based private equity entities participate more in energy industry transactions, given the region's traditional focus on oil and gas.

This locational aspect of the PE industry suggests that PE firms based in the Southwest (defined as Texas, Louisiana, New Mexico and Oklahoma) might differ somewhat in their focus. PE firms both nationally and in the region invest across a wide number of industries (*Chart 3*). Not surprisingly, Southwest-based PE entities participate more in energy industry transactions, given the region's traditional focus on oil and gas.

Of all PE transactions by regional firms since 2005, 11 percent targeted the oil and gas sector, almost triple the national rate of 4 percent.[10] In contrast, Southwest PE firms are somewhat less concentrated in the technology and communication sector (10 percent versus 14 percent nationally) and in business services and media (12 percent versus 16 percent nationally). Southwest PE firms tend to invest in other industry groups in fairly similar proportions to national trends.

Regional Advantage

PE is an important source of capital for emerging companies and mature corporations. Firms in the four-state Southwest region hold $31 billion in ready-to-invest capital, a significant amount in the context of the $51 billion in business loans on the books at banks in the Federal Reserve's slightly smaller Eleventh District.

Like much of the financial services industry, PE is in a period of transition borne of economic turmoil and regulatory change. Some firms have moved outside their traditional boundaries. Yet the increasingly global industry retains its regional flavor, reflecting a desire to capitalize on the advantages and specialized knowledge of industries at home.

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Notes

[1] As measured by total funds raised in the past 10 years. The Eleventh District encompasses Texas and parts of Louisiana and New Mexico.

[2] This compares with the U.S. total of $1.65 trillion raised over the past 10 years and $455 billion awaiting investment, known in the trade as "dry powder."

[3] Growth equity and mezzanine debt are both very flexible, diverse strategies and may pursue firms at any stage. For simplicity, we focus on their preference for mid-cycle companies.

[4] See "Playing to Their Strengths? Evidence that Specialization in the Private Equity Industry Confers Competitive Advantage," by Robert Cressy, Federico Munari and Alessandro Malipiero, *Journal of Corporate Finance,* vol. 13, no. 4, 2007, pp. 647–69.

[5] Changes in asset values are not directly observable because there is no public market for firms owned by PE investors.

[6] All data on the PE industry are from Preqin.

[7] Venture capital funds are exempt from registration requirements.

[8] See U.S. Senate Report 111-176, 111th Congress, 2d Session, April 30, 2010, pp. 71–72.

[9] See "Corporates Outbid Private Equity for Good Assets," by Marietta Cauchi, Marketwatch.com, June 24, 2011.

[10] The data in Chart 3 are based on number of transactions. Data on the dollar amount of investments by industry are available for roughly 30 percent of transactions.