FEATURE

LISTED FIRMS

As Blackstone and other big buyout firms consider listing their management companies, **Robert Venes** looks at 3i, one of Europe's longest-listed private equity PLCs.

Making the list

Despite fevered speculation in the press as to which financial investor will follow Blackstone Group's recently announced decision to go public, these are not uncharted waters for private equity firms. "There is nothing new or unique about listing a private equity management company or fund," says Mounir Guen, head of placement agent MVision.

Indeed, the firm's decision not only follows some amusingly timed comments from Stephen Schwarzman, Blackstone co-founder and the firm's public face, regarding the public markets ("overrated" and not a viable source for capital), but also the listing in February of Fortress Investment Group.

That flotation itself followed Kohlberg Kravis Roberts' US$4.8bn IPO of its KPE Private Equity Fund Investors last March, a move that Schwarzman said at SuperReturn in February "destroyed the market for anyone else", suggesting his rival had soaked up all available liquidity.

KKR's decision meant the public could participate in private equity's boom, investing directly into a buyout fund and its underlying investments. As Schwarzman suggested, no private equity firm has followed by listing a buyout fund on the public markets since.

However, at around the same time, alternative asset manager Partners Group, which has SFr17.3bn (€10.6bn) of underlying private equity assets, was floated on the Swiss stock exchange, joining the likes of American Capital (and its London and Paris-based subsidiary, European Capital), Sweden's CapMan, Paris-listed Eurazeo and mezzanine provider ICG and 3i in the UK as private equity PLCs.

Like those, Blackstone is listing its management company, a decision that some reports suggest required Schwarzman to persuade key partners as to the benefits. Media attention has been quick to focus on how Blackstone's decision will affect it and some of its big buyout firm peers' notorious affection for privacy, in particular the profits it nets from its roughly US$55bn of investments.

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Private equity firms charge between 1.5% and 2% of a fund's total in management fees – Blackstone is understood, like many of the bigger funds, to charge approximately 1.5% – and then takes a 20% cut of profits in performance fees once its exit strategy has hit its hurdle rate of around 8%.

These terms and conditions have become established over the years – with one US general partner recently quipping that they came over with Columbus – and have played a significant factor in retaining executive talent from one fund to the next.

As the industry has come under further scrutiny, though, some have questioned the relevance and fairness of a management fee – Blackstone's latest extended fund totals about US$20bn, resulting in a management fee of some US$150m. Clearly, this is enough to put food on the table for its partners.

How transparent a listing of Blackstone's management company will make its activities and its pay structure is uncertain, with some analysts suggesting Schwarzman and his partners will ensure the flotation is carried out in their best interests.

"They're going to structure themselves where the new nuances won't be harmful to their development and won't add extra layers of complexity or visibility," says Guen.

3i, which was listed in 1994, has already been through this in full view of the public gaze.

Just a few years ago, the firm was suffering from the aftermath of the dotcom bubble, top-heavy with technology venture investments but increasingly light on executive talent. Known by many as the university of venture capital, 3i had seen many of its staff leave for better remuneration elsewhere, with the most high-profile departures being Richard Campin, Chris Graham, Hugh Richards and Tom Sweet-Escott, who set up their own firm, Exponent Private Equity, in early 2004.

In July of that year, Philip Yea took over from Brian Larcombe as chief executive, the first to be recruited outside of the firm, having previously headed up Bahrain-based Investcorp. One of Yea's first changes was to 3i's pay structure, providing compensation for executives' investments.

"Historically, 3i had been criticised for not being to market in terms of compensation to executives relative to peers at more traditional LP/GP models," says Douwe Cosijn, head of investor relations at 3i. "Since Philip Yea came on board in 2004, our compensation structures are to market, working largely on a 2 and 20 basis. Everyone gets carry and stands to do well."

According to Cosijn, compensation is disclosed for 3i's board members, but the firm doesn't provide details on the salaries of individual investment executives. As for shareholders, third-party investors in its

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buyout funds (limited partners) share in the profits alongside general partners, while the strength of the underlying assets provides a better share price for investors in the public entity, who also received dividends, such as the £800m announced in the group's pre-close announcement last month.

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Douwe Cosijn

Being listed, says Cosijn, also lends the firm credence in longevity over rivals that operate funds with 10-year life-spans and a reputation that could prove invaluable at a time when the industry is very much under the microscope.

"Given our history of being listed on the stock exchange and fully regulated, we are well prepared to deal with the spotlight of the public markets," says Cosijn. "Our management team invests a lot of time in ensuring our relationship with the public markets are open and transparent and that there is a real expectation and understanding in the City of what 3i should be doing."

Not only that, the firm can also deploy capital at a faster rate than its traditional peers.

"Permanent capital is what you get when you become a listed vehicle," says Cosijn. "So if you look at what 3i can do with a balance sheet of over US$10bn, we were able to get a team up and running in India that was established over a relatively brisk period of time with the advantage of 3i underwriting the business and its integration. We were able to do growth capital deals there almost from day one, whereas with a traditional fundraising it can take 12 to 18 months, giving us competitive advantage."

More recently, 3i has also moved more in line with its traditionally funded peers by extending the amount of third-party commitments to its buyout vehicle, as well as following the industry's trend of ever-larger fund sizes.

In November of last year, 3i held a final close on its fifth buyout vehicle, Eurofund V, having raised €5bn, Europe's largest mid-market buyout fund. 3i is understood to have provided about 55% of the capital from its own balance sheet, with the remainder coming from some 62 institutional investors.

"3i started raising third-party funds only in the buyout space," adds Cosijn, "as it enables us to take majority positions without having to consolidate assets on the balance sheet. That's important as what it does is give flexibility, while also enabling them and us to benefit from the strong deal flow that we generate."

Last month, 3i extended its faith in the public markets by floating an infrastructure investment business, raising £700m, albeit at the lower end of its targeted £700m to £1bn range. The firm subscribed to 325m shares, representing 46% of the company's ordinary shares.

"The fund is well aligned to shareholder interests as infrastructure is by nature long term and stable with 20 to 30-year contracts," says Cosijn.

A listed firm and fund's ability to tap the capital market as an evergreen source of funding could also prove invaluable during less buoyant parts of the cycle, he adds.

"Investment and divestment rates are best left to the investment teams rather than the mechanics of the portfolio," says Cosijn. "Within the context of a 10-year fund with a three-year investment and seven-year divestment period there is clearly pressure on general partners to return assets, which is not a dynamic that comes into play when you have a permanent vehicle and can take a longer-term view on assets. There isn't the pressure to make realisations and distribute back proceeds the way you would in a traditional buyout fund," he says.

"It's very important to 3i in our engagement with the capital markets that we ensure we are open and transparent about our performance and what shareholders expect from us across the cycle, especially in terms of our return objectives," says Cosijn. "At present, we have been outperforming, but if the cycle turns and there is a period where we are not meeting those objectives, we expect to have a grown up conversation with our investors."

Being the grown up is clearly where 3i sees itself in the current climate and Cosijn is confident that private equity's increasing maturity and ability to outperform public markets will ensure that others follow Blackstone onto the world's stock exchanges.

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"There will be more, it's not a fad as public markets are clearly looking to access that out-performance, not just in private equity but also hedge funds and other alternative assets," he says.

"The scrutiny of the industry will become an important theme as it moves from a boutique niche to a mainstream asset class. Having a peer group of listed private equity companies should make the valuation debate of private equity firms much richer and should put the broader industry on valuations that are in line with the return objectives that this industry has demonstrated over the medium to long term," says Cosijn.

Guen, on the other hand, isn't so sure, saying: "Almost 700 funds closed last year and we dealt with 12 full closings. You're not going to see 700 firms go to the public market, but you might have one or two, most likely at the large end."

As for Blackstone, Cosijn has little doubt that it will transfer its success as a private entity to the capital markets.

"Blackstone has a phenomenal track record and experienced management team, and while listing will be a new challenge and a move into the spotlight, they are a smart outfit that will adapt in due course to meet the demands of public markets," he says.