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In the public spotlight

BY WIETSKE BLEES

Last year's flirtation with listed funds by the private equity market will prove more than just a flash in the pan. But additional listings will prove complementary to a robust market, not indicate any fundamental change.

Despite unprecedented LP demand for traditional private equity funds, last year saw a number of buyout funds entering the public realm. May 2006 saw KKR launch its three-times oversubscribed €5bn KKR Private Equity Investors fund on Euronext Amsterdam, a move swiftly followed by Apollo Management.

"Ever since KKR launched its KKR Private Equity Investors (KKR PEI) fund, we have been inundated with requests and plans for similar listings," says Robert ten Have of Freshfields Bruckhaus Deringer, who provided legal advice to the bookrunners and coordinators of both KKR and Apollo. "We were able to subsequently structure Apollo Management's AP Alternative Assets and took on about a dozen other mandates, but demand from private equity and hedge funds was so high at the time that it outstripped our capacity. We have continued to work on multiple mandates ever since."

This is interesting as quoted vehicles are in fact nothing new. In Europe, for example, 3i is quoted on the London Stock Exchange, while GIMV is listed on Euronext Brussels. It is the size of KKR's oversubscription – resulting in a €5bn fund – that brought the issue into the spotlight and spurred the interest of the larger players.
To the outside world it may have appeared as though last year's hype was short-lived – both funds traded at substantial discounts and Doughty Hanson was forced to scrap plans for a €1bn listing altogether. But these appear to have been temporary blips in a trend that sees buyout houses take advantage of a new source of liquidity.

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MVision

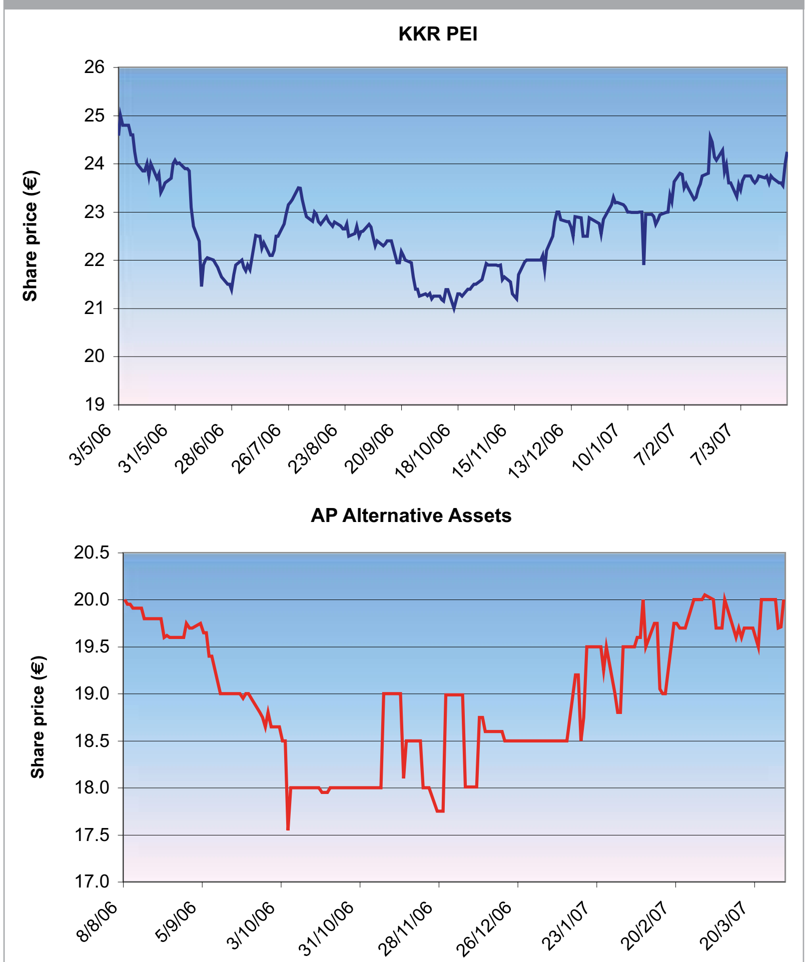
While for instance many observers blamed Doughty's failure on KKR PEI having taken the liquidity out of the market and that the stock market in general took a nosedive in summer 2006. "With uncertainty of the implications of current developments in North Korea and Iraq, indexes were stagnating and a number of listings were cancelled around that time," says Aad de Winter, director of listings at Euronext Amsterdam. "The timing to launch a vehicle last summer was quite simply wrong."

Now, as graph 1 indicates, share prices for both KKR and Apollo are back up to their offering price and, as de Winter points out: "There are a number of planned listings in the pipeline that are likely to materialise within the coming months."

"Private equity appears to be the flavour of the month," says Francois Joly, director at Probitas Partners. "For general partners, a listing is a way to take advantage of the current strength of the market in order to gain access to an additional source of liquidity."

This additional source of liquidity is substantial: listed vehicles open the private equity market up to a whole new set of investors. "Quoted vehicles allow investors that are unable to invest outside of listed vehicles to have exposure to private equity, giving them the potential to increase the diversification of their investments," says Mounir Guen, chief executive at MVision. Although short-term investment strategies are unlikely to book great successes, investors that may wish to exit from investments before the traditional lifespan expires can be attracted by the liquidity that comes with having the potential to trade shares.

Share price of listed private equity vehicles



source: Euronext Amsterdam

To the casual observer, a trend of going public may seem at odds with the operating principles of private equity, where being private is considered an advantage. This is not wholly untrue: going public involves more costs of compliance and regulatory reporting obligations to ensure transparency on performance and valuation processes, which are considerably larger than the private model requires.

But against this burden, investing from a quoted vehicle removes the need to raise new closed-end funds at regular intervals, making it not only less resource intensive, but also more permanent than a traditional private equity model. While in the current liquid climate general partners experience few problems attracting limited partners to their funds, at times when the cycle is less benign, having permanent capital is an undeniable advantage.

However, there are some substantial concerns that these funds will not give investors the returns that are commonly expected of private equity. Most noticeable has been the fact that both KKR and Apollo's shares took a dive to considerable discount levels immediately upon their debut. This was partly due to the structure of these funds, which suffered from the J-curve and cash-drag effects combined, and saw the costs of the respective IPO's being born from the proceeds of the listing. But, as Joly points out, even for those funds that have been around longer and where the J-curve no longer rules, shares have historically traded at discounts. "The current climate is very favourable to private equity and share prices paint a positive picture, but should the situation become less benign, these discounts will grow larger again," he says. Mounir agrees: "In deteriorating market conditions, it is always the liquid investments which are sold off first."

Different strokes

The truth is that the private equity model requires a patience that is unlikely to be found on the stock exchange. The operating principle of private ownership is that it shields companies from the short termism and regulatory burden of the stock market. Not only does going public involve regulatory reporting obligations, a short-termist approach to investing quite simply does not marry well with a strategy that sees value creation occur after four to six years.

"Private equity investments are long-term, illiquid investments and provided you can invest outside of listed investments, traditional limited partnerships are the better option," says Guen. "The number of investors is limited and the alliance between the general partner and its limited partners is much stronger, the level of disclosure and communication is extremely detailed."

By contrast, for newer investors, or those who are unsure about the valuation of their private equity investments, the option of investing in these funds and the availability of public information can be very interesting. As Joly points out: "The availability of publicly listed information makes it easier for limited partners to evaluate their private equity investments." And in any case, for those funds that are unable to invest in non-listed entities, listed funds offer the possibility to at least gain some exposure to the asset class.

For the traditional private equity model, the availability of a listed alternative appears to be without major implications, as most observers insist the traditional model is here to stay.

Private to public

In a market where private equity is increasingly contemplating the merits of going public, Blackstone is taking the initiative yet another step further. The firm's announcement to seek a listing, believed to be around 10% of the company, could value the firm at around $40bn. This could provide the firms original founders with a lucrative way to exit the business gracefully.

Founders will naturally want to cash in on the firm they built. Pete Peterson, now 80 years old, and Steve Schwarzman, who celebrated his 60th birthday with a bash in New York in February, set up the firm as a Wall Street boutique investment group in 1985.

Today the firm has more than $50bn of assets under management. "It would be difficult to establish the amount of compensation these founders should receive for the value they have created," says Guen. "An IPO is one of the easiest ways to do so."

But not everyone is comfortable with the recent announcement. As one observer commented: "This IPO pretty much makes a mockery of all the arguments why it is better to be private." He has a point, given that as late as December, Schwarzman was quoted as saying that the web of regulation, disclosure and quarterly earnings requirements was a brake on American public companies. Other observers wonder whether we are witnessing an opportunistic move on the part of the founders to extract value before the private equity bubble bursts.

What is certain is that any such IPO is sure to generate more than substantial interest. Those who buy Blackstone's stock will be able to share in those fees, which are directly tied to the success of the firm's investments, and will receive quarterly dividend payments. And while much of the information about Blackstone remains private, some of the figures which have been circulated suggest that the firm could not have picked a better moment. This could trigger a wave of buyout firms following suit.