The Case for Illiquidity

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A Change of Fortune. It's official. Private investments are out of fashion. In fact, since the nadir of the Crash of 2008-09, inflows to private investment funds have slowed to a trickle. According to the research firm Preqin, quarterly fundraising dropped 81% from 1Q 2008 to 1Q 2010. While private investment funds hold a reported one-half trillion dollars in unspent capital, actual investing has dropped by over half — $80.5 billion of announced and completed deals for the 12 months ended March 31, 2010, versus $170.3 billion in the prior 12 months. TIFF members have remained only slightly more faithful to private investing. While industrywide fundraising fell 61% in 2009 compared with 2008, capital raised in all of 2009 for TIFF's private investment funds dropped 54% to $165 million from $357 million in 2008.

'The Only Thing We Have to Fear Is Fear Itself.' Although investing should have nothing to do with what is in fashion, it's worth examining why the private investment asset class has lost its sparkle. It is clear to us that the answer is fear. Following the near-cataclysmic drop in equity values during late 2008 and early 2009, it was only natural that investors would fear the worst. Such emotions are powerful. Yet as my colleague Chris Douvos often reminds the TIFF PI team, thoughtful investing is about optimizing discomfort. A more clinical (if somewhat hackneyed) explanation for the decline in appetite for private investments is that the "premium for illiquidity" has increased. We can all agree that private investments are less liquid than marketable investments, and we should acknowledge that investors in private funds deserve a material return premium over liquid or marketable funds. Indeed, we strive to achieve this material outperformance in all our private equity funds. So, what has driven the cost of illiquidity higher? Again, the answer is fear — fear of over-committing capital to private investments, fear of material underperformance, fear of scandal, and of course the fear of being alone when most investors are retreating from the asset class. At such times, some investors take the uneconomic decision to sell interests in private funds on the secondary market at material discounts to net asset values. TIFF's secondary funds have sought to capitalize on this trend. In fact, we believe that "going out of fashion" is the best thing that could have happened to private investing. Perhaps we will be criticized for being too contrarian, but we believe that the case for taking illiquidity risk, argued in the paragraphs that follow, is stronger now than it has been for several years.

Pricing Seems Better. Our private investment managers have told us that, in general, prices of the assets they seek have declined. This is certainly more true for buyouts than venture capital. Their view is reinforced by recent data, which suggest that 2008 ushered in a strong buyer's market as the average purchase price to EBITDA multiples for LBOs declined from 9.3x at the peak in 2007 to 7.2x in 2009.

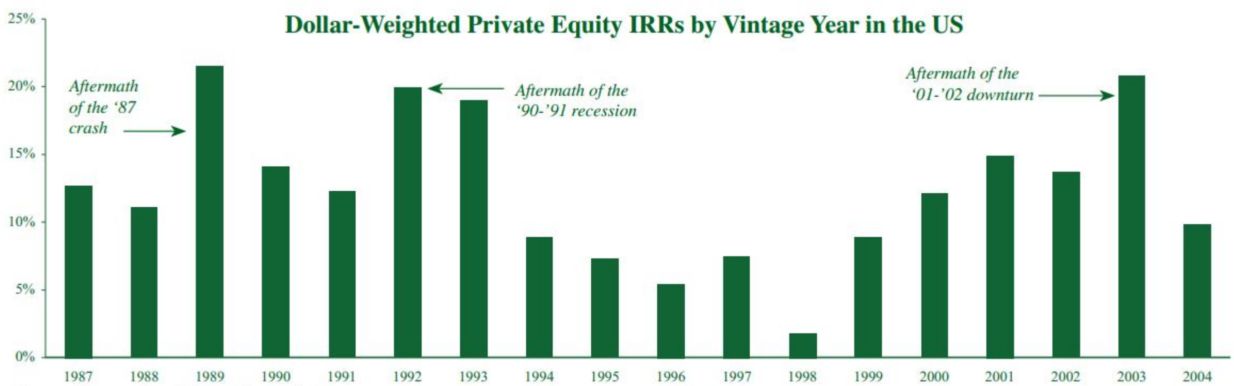
Certainly the dearth of deal activity in 2009 has significantly reduced competition for private assets. As investors, we are strong believers in the notion that most of the return from a private investment should come from good old-fashioned revenue growth and profit enhancement. At the same time, we appreciate the power of multiple expansion — better known as "buy low, sell high." In recent years, we worried about possible multiple contraction for private investments from purchase to sale. Today, we believe there is a strong case for the opposite.

Scarcity of Capital. At the peak of buyout activity, capital became a commodity, and time-to-closing was at a premium. We heard from our managers of transactions in which prospective buyers were given only five days to conduct due diligence and were offered no access to company management. In other cases, deals were sealed only if the buyer signed a purchase and sale agreement nearly devoid of representations or warranties made by the seller. Yet deal auctions conducted under these ridiculous conditions actually resulted in numerous closed transactions. In the current environment, the tables have turned. Capital has regained its rightful place as a strategic resource, and time is very much on the side of the buyer. It is much more difficult for a seller to hide problems. Less competition, better due diligence, and more time to completion should contribute to more successful transactions — with investors bearing far less risk and securing better downside protection.

Where Are the Banks? Of the most notable changes in the private investment world, none has been as rapid and radical in scope as the retreat of lending institutions — commercial lenders, mortgage lenders, investment banks, hedge funds, you name it. Competition among providers of debt capital had become so intense in 2007 and 2008 that debt-package proposals for buyouts were ranging up to about 10x EBITDA with few if any covenants. Credit reviews were shortened, due diligence was curtailed, and a debt bubble ensued. During a booming economy, returns from heavily leveraged transactions looked good. But we never believed this would be a sustainable strategy, and of course it wasn't. Since the end of 2008, buyout firms have had far more difficulty finding lenders. Today, limited lending activity seems to be creeping back but at appropriately sober levels. The good news for investors is that deals can no longer rest on the crutch of financial engineering. When debt was cheap, plentiful, and came with few strings attached, higher purchase prices were inevitable. Now, managers need to make deals work based on their ability to transform good businesses into world-class companies. There are fewer managers truly good at this, but their returns are likely to be sustainable and more consistent.

The 'Partner' Is Back in 'Partnership.' Although it may seem trivial, a renewed focus on true partnership between General Partner (GP) and Limited Partner (LP) may be the financial tsunami's most valuable contribution to private investments. At least two key trends seem to be occurring: 1) LP-GP discussions have shifted to a more positive tenor and 2) alignment between owners (private investment funds) and their management teams (portfolio companies) on business goals has improved. The second point is far more subtle but equally important. The improved alignment is occurring during the period of courtship between a private equity acquirer and its target. Because few companies are being put up for sale today with the objective of maximizing proceeds, deals are happening when founder-owners genuinely believe that their private equity counterparts can help them with knotty business problems — for example, how to staff a business for growth or how to capitalize a business to provide greater stability during expansion. It is far more unusual today to find a seller cashing out because pricing is good and life is short. The result is better alignment between owner and manager, both in economic terms and in striving to achieve similar long-term goals. This, in turn, should have a positive effect on returns for investors.

What Lies Ahead? Rather than engage in a windy wrap-up or in earnest fortune-telling, we would prefer to simply direct our readers to the graphic below. While reminding them that past results are not necessarily indicative of future results, we can't help but point out that some of the most successful private equity funds, in terms of performance, were raised in vintages immediately following deep recessions.



Source: Thomson One (Venture Economics)