Lecture Text

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Boom and Bust in Private Equity

(*edited for clarity*)

Introduction

Welcome. I'm Josh Lerner. I don't know what we billed this as—"Boom and Bust in Private Equity"? Boom or bust? I guess we know what the answer is. If it's posed as a question, we're pretty clear on what the answer is.

What I thought we would do today is spend a little bit of time talking about where the private equity industry is and how we got to where we are. But we'll spend most of the time thinking about where the industry is likely to be going over the next decade in light of the extraordinary stuff that's happened. Clearly, this is a topic on which you can spend a lot of time. There are a lot of issues out there and I'll only be able to really touch the tip of the iceberg.

What I'd like us to do is go back in time and spend a little bit of time thinking about how we got to where we are today in terms of what the private equity business looks like. I'll do that very fast and then we'll get into the more interesting question, which is what we're likely to see going forward in terms of where the industry is.

How Did We Get Here?

Let me begin by emphasizing a couple of points before we get into the nitty-gritty of history. The first is that private equity clearly, even today, is a relatively young business, relative to most industries we think about. At the same time, it certainly has been characterized by a lot of instability, a lot of flux, and a lot of change. But at the same time, the fact that it's here and the role that it's playing aren't accidents. There are some really, really good reasons why it's here.

Pioneering funds, 1946-1977

General Doriot was, of course, the founder of the first venture capital firm, American Research & Development, which was set up in 1946. Among many other things, including being a professor here and being a founder of INSEAD, he had very much been at the heart of the planning process at the end of World War II, where there was a real concern about the state of the economy and how to help the United States not fall into a recession. And he had come up, along with some other leaders in the Boston community, with this vision of venture capital as a solution to these problems. A new organization could very much address some of these issues.

If we go back to the time when General Doriot and his colleagues were thinking about setting up the first private equity group, you essentially had a situation where there were the wealthy and the entrepreneurs, but there wasn't a lot in terms of formal mechanisms for them to go out and raise this money. While certainly entrepreneurs would succeed in raising money from the Rockefellers or other wealthy families, the process by which it worked and the efficiency with which it worked weren't great, and there were certainly a lot of good ideas that basically languished from a lack of funding. There was the sense that these angels had real limitations in being able to fund projects.

Even though today the idea of a private equity fund might seem like it makes a lot of sense, it turned out to be tremendously challenging to raise the money. And when General Doriot and his colleagues went knocking at the door of, for instance, the Harvard endowment, and said, "We have this great idea for a new financial intermediary," it basically was slammed in their face: "This is a crazy, risky idea that doesn't really make any sense here." So they ended up with a very funky, publicly traded structure, which essentially ended up being largely sold by brokers to widows and orphans who really didn't know what they were getting themselves into.

However, it basically was the right idea, and it's very fascinating to look in Baker Library at General Doriot's writings around that time and think through what a private equity fund was all about. What he really emphasized was that banks and individuals or others really couldn't do the job that they wanted. They needed some new financial institution that could play several different kinds of roles. First, the kinds of problems that these young companies had—whether it's a lot of uncertainty or the fact that the entrepreneur knew a lot more than the investors did about the particular area; the fact that there weren't any hard assets to lend against; and the fact that there were these market cycles where there were booms and busts—made it tremendously difficult for them to provide financing.

And his vision was one of a very new kind of organization that would do a lot of sorting out. So in other words, instead of funding essentially like a bank, which might fund one out of three loan applications coming in, here we'd be funding only one out of a couple hundred that were showing up. Secondly, that there would be this very intensive monitoring, not just in terms of receiving quarterly statements, but in terms of really providing that intensive oversight of the companies. And finally, this idea that there would be some real stamp of approval being provided by the private equity groups. This wouldn't be just a matter of a small company getting funds, but it would take on the aura of whoever was providing the financing with them.

At the same time, as we alluded to, this publicly traded structure really didn't work very well. The share prices would be bouncing up and down, and it would be hard to do follow-on offerings, especially when things were really depressed and there might be some really good investment opportunities out there.

And you get a second real insight into how this process worked most closely associated with William Draper, who formed the first limited partnership to do this rather than trying to pursue this activity through a corporate structure. The idea was that we'd raise the money, we'd hold it for somewhere on the order of ten or twelve years, and then we'd be forced to give that money back to our investors. It would provide some real degree of discipline as part of the process. It would also be a very clear rule in terms of how to split up the profits—80 percent to the investors and 20 percent to the private equity group—which would also be a way to allow some powerful incentives if everyone did well. So you ended up in a situation where over the course of the '60s and early 1970s, this limited partnership structure became the dominant way in which private equity was set up in the country.

Hyper-growth, 1978-1987

Then we get into the beginning of the modern era. We have what at the time was seen as a very minor technical correction by some faceless bureaucrat in the Labor Department that ended up having huge implications, which was a change in the definition of a "prudent man." This prudent man definition said that if you're a pension fund, all your investments have to be in stuff that, if a prudent man were to look at it, he would say that this is indeed a reasonable and sensible investment to be making. And many of these pension funds were scared in terms of going into venture capital, because they said, "We give money to venture capitalists and then they'll give it to some crazy eighteen-year-old kids with ponytails in some garage in Palo Alto. That prudent man is going to look at these crazy kids and there's no way he's going to say that this was a reasonable investment." And this change simply said that if you're putting some slice of your investment into this asset class and it's being managed by people who are responsible and professional investors, then it's OK, even if they're putting it into all sorts of wild and crazy stuff.

Again, it's not surprising what happened, that even though most pension funds made very minor changes in their allocation, the amount of money collectively was way larger than anything that we had seen before. We had lots of funds rushing in, the beginning of not only a much larger industry in the United States, but also internationalization. We had this very dramatic growth over the course of the 1980s.

And then as many of these groups turned out to be not that well set up, not that well thought through, whereas good groups would just raise way more money than they could deal with, things went downhill and got ugly in a hurry. So returns on the venture side, after looking very good for most of the '70s when no one was investing, spent most of the '80s somewhere around the level of treasury bills, which clearly on a risk-adjusted basis was pretty ugly. And buyouts were pretty much the same story a few years later.

Retrenchment and revitalization, 1988-1996
Anyway, what happened? Here we're getting to familiar territory. As many of the amateur groups that were perhaps less well thought through started getting out of the market, as groups cut their sizes and raised smaller funds and got better foundations, and as there was less competition for transactions, we ended up where it was a much better market for these kinds of investments, and returns started going up. And again, once the returns started going up, it attracted a whole range of people. It's also clear that the sophistication of the investors grew, as intermediaries, these investment advisors and others, came in and made a pretty chaotic process at least a little more systematized. So now you have investment advisors and others.

The private equity explosion, 1997-2000
Finally we come to the recent period, where you have this hyper-growth, where a lot of the same characteristics of the earlier booms repeated, but on a level that was much larger than before. And we can think about all the crazy things that happened. We could spend the next hour doing nothing besides talking about crazy things that we saw in 1999 and 2000, but we won't. But we can think about the challenges the buyout groups faced as many of them struggled to try to reinvent themselves and wandered into areas where they probably, at least with hindsight, feel they shouldn't have been, like real venture capital investments or telecommunications infrastructure, and so forth. And then we have the crazed nature of the venture space, where you have lots of these new competitors coming in, which led to the pell-mell race to do deals at any cost and with very limited due diligence in many cases. So you got a very ugly picture indeed by the time we got to 2000.

New retrenchment, 2001 and beyond
And we know what happened then. All the restructurings of portfolio companies, the slowdown of the investment rate, the angry limited partners pounding on the door saying, "We want money back," and so forth. And this is not just the U.S. story, but we can certainly think about elsewhere in the world. In many cases, it's more severe there rather than less. So just to go back to the picture I showed, what before was the mountain that went up to here, given that we needed to rescale this, is now just a mere foothill over here

compared to what happened in the late 1990s. As you see, I'm adjusting for inflation, so this isn't an inflation story.

And the other thing to highlight is that although venture went up, most of the action during the '80s had still been dominated by the buyout industry. When we get to the 1990s, that gray venture space got up to being close to half of the mix. And if we were to really do this right and not look at what label the group puts on the door but actually look at what they're investing in, it would probably be even more because there were a lot of buyout groups that called themselves buyout groups but were still doing some pretty funky things that looked a lot closer to venture capital than anything else. And we also saw that same thing outside the United States, again, mostly in Europe, but some elsewhere as well.

And returns, just one last thing in terms of history, just like it was ugly before, here the venture space is ugly again. The ups were bigger and the downs uglier in terms of the changes. We can talk about these return numbers and what they really mean because they are really funky kinds of things and you can't really believe them totally, but they nonetheless give a pretty good sense as to what's happening.

Three Themes
I want to highlight three themes that, if we were to look at what the private equity business will look like a decade from now, we would see as dominant issues, which I'm calling rightsizing, structure and reach, and transparency.

Rightsizing
What do I mean by rightsizing? We've had enormous amounts of fluctuation in terms of the amounts of private equity being raised, not just in the last couple years but over the whole series of decades. We've had this boom and bust, boom and bust cycle. When you look at the various trade magazines, and so forth, everyone's obsessed. How is fund-raising this quarter relative to last quarter? What do things look like today relative to a little bit ago? IPOs in August are up, things must be getting better, and so forth. I think it's easy to get caught up in the short-run fluctuations, the short-run ebbs and flows, and only focus on those dynamics. And it's helpful to step back at least occasionally and say, what are some of the longer-run drivers of what's going on?

Repeating cycles
Now, of course it's not to deny that cycles exist, as we've highlighted. You can go back in time and find in this business again and again the same process of the good returns leading to more fund-raising, leading to the lowering of standards for investments, leading to the overshooting of investments. This is clearly a fundamental characteristic of this business. And then suddenly the music stops and the investment climate changes, and I think it's fair to say that this is probably a fundamental feature of the private equity business because of those information problems and because of the opaqueness of trying to really figure out what's taken place here. The fact is that you have to make these commitments for ten, twelve years and it's hard to get out of them if you want to. This is probably always going to be a business that has a lot of booms and busts. But at the same time, I think it's a mistake to just focus on the short-run ebbs and flows and not say what the longer-run dynamic is in terms of where the business is going.

And we like to use this as a framework, which I won't belabor here in the interest of time, but there are things that are driving the supply of funds, things that are driving demand, and there are both short-run and long-run things going on. And the important point is that the stuff in that bottom right-hand corner, the drivers of the long-run demand, probably are the most important parts of the story that we often just pass over when we're focused on these day-to-day shifts in events.

Positive developments
While we certainly can find a lot to worry about in the short-run dynamics and thinking about how long the process of recovery is and how it works its way out, it's hard not to be at least somewhat optimistic about some of the longer-run factors and what they imply for a level of private equity activity. And you can think about several of these things—here's just one. I just put together a couple of examples of things that seem at least to suggest that things are not perhaps as grim as they might seem. This looks at patents that are awarded and applied for by U.S. inventors. Because you can say, "Isn't the fundamental innovativeness of the firm in a way the heart of what's really going on here in the venture capital side of the funds?" Without a strong engine of innovation, it seems unlikely that one's going to have a dynamic venture capital industry.

And here you see an interesting story, which shows that the amount of patent applications, in this heavier blue line, were roughly flat for much of the twentieth century, but somewhere around '82, '83, '85, you start seeing the upsurge in the amount of activity taking place here. If you look at other indicators of innovation, you see much of the same kind of story going on. And it suggests that something might be taking place there.

Thinking about things on the private equity side of the fence as well as on the venture side, this is more of a two-sided story. You have a situation where many of the firms that were providing competition for these groups—the large corporate acquirers—have ended up going out of the market as their strategies have come undone. At the same time, that's a little more two-sided or two-nuanced, because essentially it means, yes, there's less competition going into the transactions, but it also means that there's less opportunity for selling these companies once it comes time to exit.

Attitude change
Probably the biggest change is in attitude, in where people see themselves, what they see themselves doing or wanting to do in their lives. And particularly when you look at the generation of students now, the attitude that immediately upon graduation I want to go and make $10 million in eighteen months and buy an Internet business has clearly gone by the wayside. That was the flavor, the Kool-Aid was drunk, the crazed activities happened, and that's gone by the boards. But now you still see this very profound sense among many of the students in seeing themselves ultimately wanting to end up in environments that are smaller, more entrepreneurial, that have a kind of flexibility. And this is not necessarily a Harvard phenomenon or even a U.S. phenomenon. It really is a more global change in terms of where people see themselves wanting to work.

Steady-state level
So when we look at where the level of fund-raising is in the private equity industry, the peaks that we saw in '99 or 2000 aren't necessarily the right steady-state levels. At the same time, I don't think that the troughs of the late '80s or early '90s are the right levels either. The level we've seen in the last couple of years is probably close to the steady-state level where we'll stay for a pretty considerable amount of time. Though clearly there will still be the kind of cycles that we've seen.

Concentration of funds
That being said, there is one change we're likely to see going forward, which has to do not so much with where the level of private equity would be raised but where that money is

going. When we look at what's happened during the 1990s and early 2000s, we've seen a story where the money has been increasingly concentrated in the United States and in Western Europe. There's been an increasing single-minded focus of private equity funds in these places. That's not surprising, because that's where the returns have been—returns have been considerably higher. People have been able to get out of investments. Many of the funds operating in developing countries have had mixed experiences. There have been some really well publicized disasters in some cases, where people not only didn't make good investments but in some cases actually engaged in self-dealing and other kinds of behavior.

So we have had this story where the share of private equity fund-raising, when you go back to 1990, was 40 percent to the United States and Canada, around 30 percent to Western Europe, around 30 percent to the other, which is in the green there [on the chart]. And the green has been pretty steadily shrunk during this time while the United States and more recently Western Europe have grown in the share of money being raised. Even though the experience in developing countries has been pretty mixed in most of the funds that were raised during the 1990s, I still think that going forward this is an area where we're likely to see the share of private equity being put to work growing, whether it's in the form of funds based in these countries or else funds based in the United States and Europe, putting a larger chunk of their funds into these markets. So, that's where I come down on this rightsizing.

Structure and Reach
The last themes have to do with how private equity is run as a business and about what kind of changes we're likely to see.

Changes in the business of private equity
In some sense, it's fair to say that traditionally private equity was run in a very informal way, which had a lot of craft aspects to it, where essentially it was a small group of individuals working closely with each other in a highly collaborative and not very systematized kind of approach. And today there are changes that are pushing in the direction of looking differently. Partially it has to do with the investor, who is giving the money—there's a changing mix of the key sources of funds for these groups. Partially it has to do with the demands of portfolio companies and what kind of help and assistance the companies that are being funded need.

The investment banking industry
And I like to use one analogy, which some people may think is inappropriate and other people may agree with. It has to do with the changes that took place in the investment banking industry during the 1960s and early 1970s. And when we think about the late 1950s as the banking industry was organized, you can characterize it as an industry that was quite static in terms of having a rather pyramidical structure with bulge-bracket groups and mid-tier and lower-tier organizations that had been relatively stable since the Great Depression.

And why was it so stable? Well, at least in large part, it didn't have to deal so much with the fact that the mid-tier banks didn't have people as good as the bulge-bracket organizations did or couldn't go out and build up their capabilities. But there were very strong incentives for staying in line and staying in one's place, which largely had to do with the way in which transactions were syndicated down the chain. And if you stepped out of line or you tried to move out of your station, you would get rapped by your elders and betters and you basically would be cut out of the share of distributions of these transactions. So the situation was quite hierarchical, and it was not necessarily clear that the banks were that different, but it was quite stable in terms of how it was organized.

Changes in the 1960s and 1970s

What happened in the '60s and early '70s to upset this applecart? One big thing was a huge expansion of the volume of activity. You suddenly had a much bigger volume of securities underwriting being done. Similarly, on the trading side, the volume of transactions just went up. Meanwhile, on the demand side, companies were suddenly saying we just don't want the same old plain vanilla help underwriting this offering; we want much more in terms of analysis around mergers and acquisitions or in terms of research support and other kinds of demands for services. We saw the early stages of internationalization and other kinds of things.

Suddenly there was much more disruption of this established hierarchy across investment banking groups. And we can think about lots of examples of this, the DLJs [Donaldson, Lufkin & Jenrette] who took a contrarian approach in several ways, really emphasizing building up on the research side, also taking an aggressive approach by raising a lot of capital by going public very early on. You can think about Merrill taking what was a highly regionalized or localized business of brokerage and investing in information technology and building it into a national and then international business.

And then we've clearly also got the losers, the people who were bulge-bracket or leading groups during those days who said we're not really changing during this period, and gradually stepped down the ladder and eventually faded or ended up getting acquired.

Another thing that you ended up seeing during this period was that the differentiation between the bulge-bracket groups and everybody else grew wider. It's not that there weren't bulge-bracket groups and mid-tier groups and lower-tier groups by the mid-1970s; that continues to this day. There is a range of different groups. But you suddenly started seeing that the differences between those bulge-bracket organizations and everyone else—the gap ended up becoming considerably wider. And in terms of whatever you want to use as measurements—whether it's number of investment professionals, the relative profitability per managing director, just simply the scale of the procedure, even the way in which these organizations were run in terms of how systematized and how formalized a lot of the process was—became considerably different between the top-tier groups and everyone else.

One possible road map

Now, maybe it's a radical idea to say that this provides some road map for where the private equity industry is going, but I think it's worth thinking about this as a possible analogy for where the industry might be evolving over the next decade. And in particular, I certainly think it's highly possible that we'll end up with one band of firms that really is much larger in scale and probably in global reach at the top tier or the bulge bracket. We'll have another whole set of people with much more focused strategies—well-defined, narrower strategies that are doing very well but that are much more modest in terms of scope, to a certain extent. And perhaps we'll see the groups that are the mid-tier groups—the guys who are in the middle who have a variety of different strategies and approaches but without any really clearly defining different approach and without the massive scale—as being the people who have the most problems.

So here we have a world where we start off with everyone pretty much looking the same. Then you essentially get the differentiation and the emergence of some large global funds on the one hand and niche funds in the other. And the question is, are those people who are sitting in the middle without either the narrow specialization or the global reach really going to disappear?

Transparency
The third issue has to deal with the whole question of transparency.

Dissatisfaction of limited partners
Clearly, today there are a lot of grouchy limited partners, and this is something that we get a chance to often see when we go to these conferences and people start coming up to us complaining and saying, "You guys are supposed to be critical academics. You spent too much of the '90s cheerleading for the venture industry and you're as much a problem as those greedy venture capitalists." It's clear there are a lot of grouchy people out there who are mad at everyone. And you can understand why their limited partners are unhappy. There is a real sense that they didn't really understand what the groups they were giving money to really were doing with those funds. They thought they were giving money to a group that had a great track record doing, let's say, financially engineered leveraged transactions, and it turned out they had half a dozen dot-com investments in their portfolio.

But I think there's also a little bit of an element where they're mad at themselves. You know, they wake up in the morning after the binge and they say, "I really did that? I really agreed to those levels of management fees on a fund of that size? And I did this?" So there's a little bit of this element where it's partially our fault and that we're mad at the world anyway.

Changing investor mix
That being said, even independent of the '90s hangover phenomenon, I think a lot of the pressures for transparency and disclosure would likely be here anyway. When we think about what's happened over time, it's clear that this was a business that was very much, in terms of investments, pioneered by the university endowments and high net-worth families. During the course of the 1980s, we saw the wave of corporate pension funds getting into it, and in the 1990s we saw this entry of public pension funds and various international bodies that often had a strong public sector affiliation coming into this space. And when we think about this process, it's clear that having public investors is an important part of the mix; it creates different expectations and almost inevitably creates different kinds of environments in how information is kept and disclosed.

Changes in the money pool
When we think more generally about how the whole pool of money is likely to change over the next twenty or thirty years, we'd have to say that this trend is probably likely to increase. We know that there's been this big shift in retirement savings in the United States—and we're earlier than the rest of the world—from the traditional corporate pension fund, the traditional defined benefit plan, to a world of defined contribution plans where people have individual 401(k)s and so forth. And traditionally, a lot of those defined benefit plans were the key source of money for these private equity groups. It seems almost inevitable that a lot more of the money is going to come from individuals and others, perhaps bundled together by new kinds of intermediaries and others. Plus I think it's almost inevitable that you're going to have situations where limited partners are increasingly pushed for secondary markets, and so forth. So we essentially see a variety of things coming together that are leading to a lot more pressure for the business being run in a more transparent kind of way.

Transparency is healthy
In some ways you can argue that transparency—at least when it comes not to the information on portfolio companies but to how well groups are doing, what the returns of different private equity organizations are—is in a lot of ways a healthy thing. When we look at the experience, for instance, of mutual funds, you can attribute a lot of the growth to the birth of reporting services like Morningstar; not that people didn't invest in mutual funds before that, but it certainly made it a much safer and more conventional choice for putting people's assets into this class. And, similarly, more transparency has the potential to open up private equity to lots of investors who might not consider it or might be reluctant to come into it today. But it also has the real potential to lead to more efficient markets. We've got what historically has been a very wide dispersion of returns becoming much more concentrated. We'll probably have a situation where the bad groups, the groups with poor returns, are going to be cut off and not be able to raise capital much more quickly. Similarly, it seems the groups that have really sustained superior returns will have more pressure, either because they get lots of people wanting to throw money at them or else because people figure out that they're the real winning strategies and get a lot more imitations as a result. And you can really think about this question of efficiency and say is this a good thing or a bad thing, and there's not really a clear answer.

Profound effect
Whatever else you can say about it, whether you think it's good or bad for the industry, it's likely that the pressures for transparency will have a pretty profound effect on the private equity business going forward. And in some ways it's healthy because there will be fewer rocks to hide under. People who aren't performing well will be revealed much earlier on in the process. Similarly, it will lead to a situation where there is more accountability for private equity groups, which in some ways might be quite healthy; in other ways, if people don't know the right questions to be asking, it might be more problematic. There is another possibility that we can throw out there—I'm not sure if this indeed is the case—but it might lead to a situation where more of the pie ends up in the hands of the limited partners rather than in the hands of the general partners, which clearly is bad news for most of the audience here, not to mention for Harvard Business School's development office. But be that as it may.

Wrapping up
So let's wrap up and say what have we discussed here. First is that, when we think about the private equity business, when we think over the last couple of decades, it seems clear that change has been the rule rather than the exception. The kind of turmoil that we've seen in the last few years certainly is not something that is extraordinarily different from what's happened in the past. Similarly, while the patterns we are seeing today aren't necessarily that different from what they were, I think the magnitude of the shifts is much more dramatic, and what we're seeing is, in a broader or more exaggerated way, a really interesting crossing point for the history of the industry. And the other thought that I would end with is that when we think about where private equity will likely be ten years from now, it's likely to be looking quite different in terms of its setup, how groups are organized, and the very spirit of how the business operates, even if the fundamental process of making the investments isn't going to change dramatically.

So I'm just going to end by thanking everyone for the attention and all the questions. It was great.