A year in Private Equity

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A year ago, I joined the FTSE100 listed global private equity firm 3i, as Managing Partner for 3i North America and Asia to help develop the company's businesses outside of Europe.

One of 3i's competitive advantages is its global footprint in the middle market, with approximately 60% of the assets it manages in companies headquartered outside of the UK.[1] The demographic trends towards the internationalization of business and the increasing importance of Asia to the global economy make 3i's global network uniquely positioned to take advantage of this global growth in middle market companies.

After 15 years with GE Capital, I knew the transition to private equity would be challenging. However, when Lehman Brothers filed for bankruptcy protection on my first week in the job, I realized that the change might be even more tumultuous than I imagined.

Undoubtedly over the last 12-18 months, the market has dramatically changed; the unprecedented downturn in the financial services industry and global economy has led to a substantial and sustained decline in investment levels and I believe the market conditions ahead of us will continue to be challenging for some time.

The financial turmoil over the past year has certainly changed the face of Private Equity in both positive and negative ways. On the negative side, the lack of available debt financing has significantly limited the volume of LBO transactions. On the positive side, this situation creates an opportunity for Private Equity to be part of the solution, helping small and mid-size companies grow by providing growth capital, operational expertise and connectivity to global markets.

Simultaneously, with the financial services crisis, Private Equity is facing an enormous challenge in potential regulation; which if too hastily enacted and with unclear objectives, could undermine the important role of the Private Equity industry and stifle the progress of growing firms across the US, at exactly the time in the cycle when support is most needed.

The fact that governments are pushing for more regulatory transparency over Private Equity is understandable - and the industry has made significant strides in enhancing its own

[1] Correct at 30 September 2009

transparency to its wider constituents beyond its Limited Partners. However, increased regulation needs to be considered in partnership with PE firms to provide a reasonable solution that does not restrict Private Equity's ability to stimulate growth for business and the economy.

The key to success in Private Equity over the next 12 months will lie with an intense focus on maximizing value from existing portfolios, while carefully making new investment as the market starts to recover. In addition, having products that address the current market opportunity, whether they are distressed debt, growth capital or middle market buyouts will be critical to finding good deals, maximizing returns and, ultimately, investment success.

Having the right team in place is also critical. Along with Ken Hanau, who leads 3i North America from our New York office, my first priority was to conduct a strategic review of our US operations and reassess our investment strategy. As a result, 3i Group decided to de-emphasize our focus on the US venture market, sell early-stage investments where we could achieve good value in the secondary market and re-deploy that capital to other product lines where we see greater opportunity such as Growth Capital.

3i's Growth Capital business focuses on more seasoned middle market companies at a later stage than venture, somewhere in the middle of a pure LBO and a venture deal. 3i's own Growth Capital deals are characterized by up to $250m of equity funding for international growth alongside business owners and managers. We find our growth capital product is extremely attractive in the current market to ambitious entrepreneurs. By partnering with management teams to grow their companies without adding a big debt burden, we are able to effectively compete even in today's liquidity-constrained capital markets.

Coming from a leadership factory such as General Electric, I continue to be surprised by the lack of succession plans for major financial institutions and the problems in finding qualified outside talent to fill roles, as demonstrated by difficult senior leadership transitions at several major financial institutions. Among other things, I was attracted to 3i by its organized approach to investing, its strategic focus and the value placed on leadership. This is certainly something 3i continues to focus on as a firm through its partnerships with portfolio companies, with its own business leaders network of senior industry professionals available to us proving a key element of success.

The market disruption has created a great environment to fill out 3i's US team with solid people who bring an industry specialization, a different perspective and a new set of contacts. For example, John Moore joined 3i from Morgan Stanley's Investment Banking business as a partner to lead 3i's North American healthcare investing and to leverage his expertise globally and Sundip Murthy, formerly of Carlyle Group, was appointed as 3i Principal, to identify opportunities for Growth Capital investments in the general industrial, consumer, business services, financial services and TMT (Technology, Media & Telecoms) sectors across North America.

These appointments are aligned with 3i's overall strategy of deploying the strengths of its local networks and simultaneously operating at a global level. 3i's key differentiation in the US market is in its ability to back US-based companies with global ambition.

What can we expect for 2010? I certainly do not have a crystal ball, but I think we should be prepared for another challenging and volatile 12 months. Geographically, a company's ability to demonstrate global ambition will prove essential, as companies seek to diversify and benefit from recovering economies such as India and China, while the US and European markets will continue to be challenging for some time.

In recent years, many PE firms have been building up their teams in Asia, reflecting the relative strength of these economies versus the rest of the world. 3i has had a practice in Asia for over 13 years with a terrific track record. China, in particular, has been a great market for 3i, where even in the 2009 downturn, 3i generated strong returns through impressive growth at both PCD Stores, A $1bn luxury department store chain (December 2009 IPO), and Little Sheep, China's third largest fast food chain and hotpot specialist (in a sale to US owner of KFC and Pizza Hut, Yum Group, returning well over 3 times its money). 3i's network, local expertise and contacts in Asia can be extremely useful for a small to mid-size U.S. firm looking to expand overseas.

The debt markets have and will continue to come back slowly, but not to the levels seen over the past several years. This will put increased pressure on finding proprietary deal flow at lower purchase multiples which do not require significant levels of debt financing. I expect the trend for smaller investments with a higher proportion of equity could continue for some time.

In addition, many PE firms are wrestling with the right model to add operating expertise to their portfolio companies. Improving company cash flow will become increasingly important to PE success given reduced debt levels and anticipated slower multiple expansion. Hence, we should see the best Private Equity firms hiring operational specialists to take an active role at portfolio companies to enhance their long term value.

A case in point is 3i's investment in a Canadian based injection molding company, MoldMasters, where 3i helped to identify and implement improvement internationally. 3i supported MoldMasters with new hires in critical growth areas, a revised organizational structure, launch of cost saving initiatives in manufacturing, evaluation of production opportunities in other low cost regions (China) and the introduction of more structured internal reporting. The result has been increased sales and market share in Europe and Asia and a significant improvement in overall operating results.

In terms of industry focus, we believe that healthcare, financial services and infrastructure will be excellent places to invest in North America for the next several years. For example, the pressure on big pharma companies to fund clinical research for new products will continue to drive the trend towards outsourcing to lower cost clinical research providers such as Quintiles, a 3i portfolio company. Other attractive sectors in Healthcare will include companies that simultaneously spur innovation and efficiency by reducing the innovator's development costs and the payors' ongoing cost burden. For us, this will include companies that diagnose disease earlier and more accurately, make more effective and safer products and, finally, deliver care with less error and cost. Many of these companies will, like Quintiles, provide outsourced services to other healthcare companies on a global basis. We see particular opportunity for 3i in specialty diagnostics, low cost pharmaceutical development and manufacturing, regenerative medical products and clinical information connectivity. Given the rising global demand for healthcare delivery at rational and scalable cost, we think successful companies will increasingly require international networks, creating unique investment opportunities for 3i.

The massive dislocation in the financial services markets and prospect of increased regulatory scrutiny will provide unparalleled opportunities to purchase non-core divisions of full service banks, asset managers or other services in the capital markets. Inflated multiples and overpriced asset values have now adjusted to more normal levels and there is a considerable opportunity for survivors with capital at their disposal to lead consolidation in the industry. Interesting sub-sectors include wealth management, insurance and in particular financial services technology. Technology has become increasingly important to reduce cost, streamline operations, meet more stringent regulatory frameworks and improve transparency for investors. Additionally, increased regulatory oversight in the future and segregation of investing and reporting will drive a trend towards outsourcing to specialist independent service providers, as we have already seen at 3i backed Butterfield Fulcrum Group.

With $2.1bn infrastructure assets under management, Infrastructure is already a significant focus for 3i in India and Europe. Over the coming 2-3 years we remain optimistic about the prospects for infrastructure in the U.S. While this may take some time to materialize, the U.S. administration's focus on improving infrastructure combined with the large federal and state budget deficits must eventually drive the deployment of private equity capital via public private partnerships to share in the cost of the build-out. With our experience from a large publicly listed vehicle in 3i Infrastructure plc and a $1.2bn Infrastructure fund in India, 3i is well very placed to take advantage of this opportunity when it appears. We have built a core Infrastructure team in the U.S. to address this growing opportunity.

The past eighteen months have turned the global economy and the Private Equity Industry upside down. However, companies will continue to need partners to provide the private capital and operational expertise to grow. Even with moderate growth in GDP over the next several years, interesting opportunities for capital deployment will surface. The key to successful investing will be to learn the lessons from the past 18 months. Lower leverage, more focus on operations, a global presence and picking the right partner will all be critical to success.