Case Western Reserve Law Review

Volume 51 | Issue 3

2001

Comment: The Development of "PIPEs" in Today's Private Equity Market

George L. Majoros Jr.

COMMENT: THE DEVELOPMENT OF "PIPES" IN TODAY'S PRIVATE EQUITY MARKET

George L. Majoros, Jr.†

In addition to making a couple of comments on Professor Grundfest's presentation, I also have a few comments I would like to make on some of the prior speakers' remarks. As I mentioned, I work for Wasserstein, Perella, the New York-based investment bank, where I am president of the leveraged buyouts ("LBO") practice. Wasserstein, Perella has been involved in some of the largest and well-known mergers and acquisitions in history, including the recent Time Warner-AOL merger, and most of the infamous hostile battles for corporate control in the 1980s. This year we were ranked within the top five M&A advisory companies within the United States. Our private equity business has been in existence since 1988. So that's the perspective I have. Also, I previously practiced law at Jones Day for seven years. Unfortunately I did not have the foresight and wisdom that John McIlwraith, our speaker this morning, had. He knew that he wanted to work in the private equity industry long before I did. I had no idea until I started at Wasserstein, Perella in late 1992.

In terms of the private equity market, generally, I do not want to repeat too much of what was said this morning, but the market is huge, with $160 billion dollars or more having been raised this year from institutional investors. Probably $80 billion of that will be directed toward LBOs, and buyout firms need to find places to put that capital to work. The only way buyout firms make money is by putting money to work and basically keeping twenty percent of the profits. Along the way, buyout firms also get anywhere from a point-and-a-half to two points for an annual management fee, but that is a little deceptive because of the way private equity firms work today. That management fee gets returned before we get our profit. So some of the comments that Professor Grundfest made relate to how private equity firms must modify their approach and formulate investment

† Managing Director, Wasserstein, Perella & Co., Inc., and President and Chief Operating Officer, U.S. Equity Partners, New York, New York.

strategies when the traditional methods are not working anymore since there is so much more money to invest. Accordingly, many private equity firms began investing in so-called "PIPEs" (private investments in public equity) investments over the last year or so in an effort to put to work some of the capital placed with them. The results so far have been disastrous.

The private equity capital expansion will continue. There are new sources of capital that will probably come forward in the next couple of years. Public pension funds from relatively large states like Indiana and New Jersey that have not participated in private equity historically will start to participate because they have seen the exceptional returns the sector has generated over the last decade or so. Leaders in the field have realized this. Also, from a global perspective, there are a number of international institutions that have realized that the private equity investment sector can produce exceptional returns and can diversify their overall portfolio. They are probably a little late, but they are starting to participate. One Middle Eastern governmental investment authority alone controls $400 billion worth of assets. This entity discovered private equity and started to make investments in private equity funds about two years ago. All of this means that private equity fund managers will need to continue to find new places to invest this capital, which may lead to the evolution of new poorly conceived investments like PIPEs.

On the negative side regarding the expansion of the private equity market, there is extraordinary competition in the market overall. Big institutional investors like CalPERS and others that have been doing this for a long time probably have more than 100 relationships with the right venture capital and LBO firms. They do not need any new relationships, so they are going to give more of their capital in the coming years to people that they have done business with historically. However, that will increase the pressure on those select private equity firms to try to find new ways to invest increasingly large amounts of capital. Inevitably, some new investment types, like the PIPEs deals we are discussing today, will arise and prove to have been mistakes.

I think there is going to be a real division between the "haves" and "have-nots" among private equity firms. If you are a well-known name in private equity and have done reasonably well, you will continue to get increasingly larger amounts of capital to invest from the large institutional investors. If you are a new firm, a startup firm, or three guys who split from an existing firm, you will have more difficulty. This is not fair, necessarily, but this is how the market seems to be evolving. The people at Kohlberg, Kravis & Roberts, one of the industry's leading firms, have not generated particularly strong returns for their investors over the last couple of years. They are out in the market raising a new fund now with very modest annual returns to investors. That is in comparison to newer fund managers with 50%, 75%, and even 100% annual returns. Again, what this means is that there will be increasing pressure on the decreasing number of firms who will be investing the billions of dollars of pension assets in the private equity sector. Inevitably, these firms will deviate from their historically successful strategies and pursue new types of investments, like PIPEs, deals where the risks may exceed the potential returns.

There is a reasonable debate about whether there is too much money chasing too few traditional private equity deals. We have heard that this morning. It is kind of a tired expression that people have kicked around the last year or two. Ordinarily, there is no limit to the creativity of private equity professionals. Sometimes it is for the good and sometimes not. If you have followed the PIPEs deals, described earlier, and if you have read *Business Week* and other publications lately that have described PIPEs deals, then you are familiar with the disastrous results these deals have produced. It is almost the "Who's Who of Private Equity" in terms of failed deals in the last two years. With the telecoms in particular, probably $500 million to $1 billion have been lost by each of the top two or three largest buyout shops in the last two years by investing in PIPEs deals. The stocks of many of these companies today trade at only a fraction of the price at which the private equity firms purchased their interests. In some cases, the public trading price today is only ten percent or so of the price obtained by the private equity firm. It will be a long time, if ever, before those private equity firms get their money out, let alone any positive return on their invested capital. They may have a seat or two on the board, influence, and a variety of other wonderful "control"-like features. But their institutional pension investors are not happy. Their investors get to watch these stocks trading on a daily basis.

This brings me to another issue in terms of the differences between public and private equity. Typically, LBO firms operate behind the scenes. We typically invest in private businesses, or public companies that we take private. We operate these businesses and make significant changes in their strategies. Normally, we do not merely conduct business as usual. This is not the 1980s, where private equity firms put a pile of leverage on a business, conducted business as usual for a few years, experienced only modest growth but still generated exceptional equity returns because the deals were so highly leveraged. Today you have to do something more. You have to change direction in the company's strategy. You have to work harder and be more creative to generate high returns. You have to expand internationally, or in new geographic or product markets. The 1990s saw the evolution of the build-up strategy and the platform investment strategy, where people acquired one basic business and added on significant acquisitions. This industry "roll-up" strategy has been employed in nearly every industry from dry cleaning to funeral parlors. Although there have been spectacular successes with industry roll-ups and platform/add-on strategies over the last several years, many of them have failed. Why? Often because the roll-up was in an industry where synergies and savings that looked good on paper proved elusive in real life. (For example, funeral parlors will probably always be a local business, no matter how appealing the opportunities may look for a national chain or "roll-up.") Many of these failed roll-ups were done by private equity firms that had too much capital to put to work and not enough traditional buyout ideas or opportunities. Accordingly, they jumped on the bandwagon too late.

So private equity fund managers have tried to figure out the "next new, new thing." For the last couple of years, private investments in public equities, the so-called PIPEs investments, seemed to be it. Of course, one main difference between PIPEs and traditional private equity investments is that, with PIPEs, the whole world can watch every day how the investment is performing. All they need to do is look at the stock price, since basically PIPEs investments are generally purchases of the public stock, with a few added bells and whistles (like modest board representation, etc.). This is very different from traditional private equity (especially leveraged buyout) investing, where the private equity firm invests capital in a private business, sometimes for as long as five to ten years, and the investors only see the ultimate results when the business is sold. Even if the business is ultimately sold for a large profit, there will inevitably be bumps along the road, most of which the investors in the private equity funds will never see or know about. A fundamental problem with PIPEs deals and similar deals where you actually make investments in public companies is that people can see how the investment is doing every day, at least to the extent performance is measured accurately by the public stock price.

LBOs are unfortunately like sausage. It tastes good, but you do not want to see how it is made. Private equity fund managers ordinarily would not want investors to watch the "in-between" period, from the time the acquisition is made until the time you sell out or take it public. Why? Because there are a lot of things that can go wrong over the short term, that ultimately get corrected. Even in deals that have produced 120% annual returns for our partners, things may not have gone according to plan. You may have to change managers of the company, change strategy. You may have to change direction. With PIPEs deals, even if the private equity firm had a sufficient level of control to make drastic changes to a company, which they usually do not have, they certainly could not be effected privately. For example, if the entire senior management of a public company were to be replaced, the public would certainly be required to hear about it, promptly, and the stock price would presumably be adversely affected. Changes in strategy or personnel can be made more easily and more privately in traditional buyout-type companies.

The IPO is a favorite exit strategy for many private equity firms, which, of course, is not available in PIPEs investments. I wanted to also comment on the state of the IPO market, and the effect it has had generally on private equity investments like LBOs. The question is whether any of these businesses should be public at all. I cannot tell you how many times I have been amazed in the last year when companies with no viable long-term business have managed to go public. All rationality has disappeared from the markets. Numerous companies have gone public with the absurd proposition that they would give away products or services for free (like Internet access, or free personal computers) and figure out how to make money later. As long as those companies capture sufficient "eyeballs," or unique users, or some other crazy metric, they would somehow become viable. The logical but absurd extreme is a free house. Somebody gives you a free house, if you allow your walls to become advertising. This is the next extreme. In many cases, particularly in the telecommunications sector, companies that never should have gone public have attracted PIPEs investments from private equity firms.

The pendulum has swung back. The lunacy has disappeared somewhat, I think. The concepts of "B2B" and "B2C" have now changed in meaning, at least in New York. In New York, "B2B" means back-to-banking. "B2C" means back-to-college. I interviewed at two or three business schools last year, schools where our firm would ordinarily have interviewed the cream of the crop. We were looking at the middle of the class and could not fill the schedule because half the class did not come back for their second year. They apparently decided to forego the last year of business school to pursue dot-com mania. We have no shortage of people on the interview schedule this year, though. So I think that it is good that some of the lunacy has gone out of the market. IPOs will continue to be important to private equity firms. However, private equity firms, like every other business owner, will only be able to take public companies with viable, real businesses, and with real earnings, or visibility on real earnings, in the very near future, rather than in some indeterminate period years away.

One of the problems with the deterioration in the IPO markets in the last year is that good companies got stuck in the congestion. We had a company with a filed registration statement with the SEC in the last six months. Our SEC comments have been cleared. But we await a less volatile market to go public. And, forgetting about the presidential election for a moment, when the Nasdaq is up fifty points one day, down 200 the next, it is impossible to take any company public. Ours is a very high-quality company that should become public. It is an on-line distance learning and training firm. The company does not sell to individuals; it sells its services to big corporations, universities, or states. So we do not have a lot of the negative attributes that Internet businesses generally have. We do not have the high acquisition costs per customer. We do not have expensive advertising requirements or gimmicks, like the well-known sock puppets used by one failing Internet company, or expensive Super Bowl advertisements that have become so common for Internet companies.

As an aside, the height of the Internet lunacy is that an Internet company recently raised over $25 million, from venture capital firms, primarily, of which $10 million went to the initial website launch party. And it was a hell of a party from all I heard. Of course, the company is on the verge of filing for bankruptcy today.

But our potential IPO candidate is a real business. We have large corporate and institutional customers like the University of Texas and BP-Amoco, for example. We basically sell our services to companies for, say, $100 a person, training people on-line. They can perform the on-line training on their own time; they can do it in the office if they want. They can do it in a supervised fashion, if the employer wants it that way. This is a terrific company that has a real reason for existing. It is a professional services company, but it has been unfairly lumped into the "Internet" category, which is the "kiss of death" in today's IPO market. The Internet is really just a distribution and communication mechanism. It is unfortunate that good, viable companies cannot access the IPO markets today because of the failures of companies that never should have been taken public in the first place, including many of the companies in which private equity firms made PIPEs investments.

The IPO markets will, of course, stabilize at some point, though it may take two years or more to do so. At that point, private equity firms will once again be able to utilize the public markets as an exit for their private investments. For private equity firms that have made investments in PIPEs deals and similar quasi-private/public investments, the outlook remains uncertain, at best, and, more likely than not, grim over the short- to mid-term.

Finally, following up on an earlier remark today, I would like to conclude with a comment on the lawyer's role with private equity firms: LBO firms are probably the greatest clients a lawyer can have, and I do not say that just because I work at an LBO firm. We provide serial business, deal after deal. Not only do you get our legal business, but you often get the legal business of the portfolio companies, as well, particularly if we buy a business, take it public, and the public shares are widely distributed. It is very important, however, to know who your client is. I have had a lot of law firms that pitch very hard for our portfolio companies' business, take them to dinner, but that ignore our phone calls. They do not quite understand the relationship between the portfolio company and the LBO sponsor firm. We are great clients. We like working with lawyers on a repeated basis, with young lawyers in particular, and we like people who understand the business side of deals. There are too many lawyers—and I think I was guilty of this my first year or so as a lawyer—who just focus on the legal documents, not the deal. They could care less what the underlying business transaction is. On an M&A transaction, the only thing that matters to many young lawyers is the legal documents and the purchase price to be inserted into the purchase contract—whether it is a million dollars or a billion is irrelevant. We like lawyers who actually understand the business, who can provide advice, and who take the time to learn all they can about the portfolio companies they are working with. These lawyers become invaluable to us and our portfolio companies. They will get our business for years to come.