



Passing parcels

The 'evolution' of the big private equity players could be taking us into dangerous territory, says **Jon Moulton CBE**

Private equity has come a very long way in recent years – and its boundaries have continuously pushed outwards. Increasingly, the mega private equity players are morphing into what were other classes of activity as they become rather large gatherers of all sorts of assets, and of course the associated asset management fees.

What were buy-out firms are now extending into property, all sorts of financial activities, hedge funds and a rapidly growing assortment of businesses that may be in funds or actually part of the diversifying asset manager. Let's call these ever-expanding private equity asset managers PEAMs.

Climbing the ladder

A few things have given rise to an ever-growing use of leverage in numerous forms. First of all, as PEAMs get bigger it makes sense to assume that the low-hanging fruit investors pick off are being succeeded by less lucrative areas of investment that require ladders. As competition for deals has risen over the years, increased use of leverage has helped keep returns up.

As a rough example, if a private equity fund has 60% debt at an interest rate of 6% per annum (which is perhaps a little optimistic) and the fund generates twice capital, then the other 40% of the funding will get around an 18% internal rate of return. Without leverage, the investor would have got around 12%. Obviously if the fund does not manage a meaningful return, then the 40% piece gets a loss, but the 60% should get out intact (most of the time).

Second, as private equity assets get bigger, so bigger players in the debt markets arrive to feast.

And more sophisticated structures surface, many with uncanny echoes of the subprime fundings of the global financial crisis. In the example above, the debt layer might itself be part of the lowest risk debt that forms the asset base of a collateralised loan obligation (CLO).

That could have, say, five layers with ascending risk and return characteristics and as you move to the least secure top layer, that layer is betting on there being an equity return out of a pyramid of loans. This is a big and diverse market; CLOs are roughly a \$1tn market and growing.

Diving into large pools

PEAMs are increasingly involved in raising and managing CLOs. CLO debt is increasingly out-competing banks to finance portfolio company debt. Some are even targeting lending to their private equity investees or funds. And that has the obvious risk of conflict of interest. Note, however, that the PEAM has found a further source of profit from its funds, to add to management fees and carried interests.

Lots of capital continues to be drawn to our world and, increasingly, PEAMs are buying their way into getting large pools of capital. Apollo has led the way in building its own insurance platform with many others now following suit, such as Blackstone, KKR and Brookfield.

Globally, private markets control \$15tn of assets under management (AUM), which to put in context is 5xUK GDP. Insurance is a growing part of this with insurance assets owned by private equity firms currently standing at \$800bn. The US insurance

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industry has around a \$40tn balance sheet. That's a tempting source of capital.

Insurance firms have vast balance sheets, which are a helpful source of AUM and theoretically, their long-term liabilities should be a good match for the more illiquid and (probably) higher returning private market operating assets.

It is worth noting that insurance firms use many of the same tools in financing their business as are used in the private equity world – risk transfer via reinsurance is much the same as using credit default swaps to move risk around the financial world, and multi-layered financing structures are not new to the insurance world.

The mess that insurance firms such as AIG got into when the markets worried that it could not deliver on its guarantees could come again. It is worth highlighting that, in part because of their history, credit default swaps (CDSs) are now called significant risk transfers (SRTs).

Fund of funds

Another example might be a portfolio of private equity funds typically holding 500-plus companies for diversification. These companies typically could be valued at an average of 12xEBITDA, and have an average debt leverage ratio of 5xEBITDA. The fund of funds manager then leverages this portfolio of private equity funds by selling a preferred equity position against the net asset value of the portfolio.

They would do this because they expect that the return on the preferred equity (equity can lever, too) will be below the return on the fund portfolio, so they are increasing the IRR for the ultimate investors and (often as important) provide significant cash liquidity to the fund's own investors – and perhaps some carry.

The net asset value is generally equivalent to 7x EBITDA (12x EBITDA valuation – 5x debt). Preferred equity providers could be a bank, private equity fund or a hedge fund, so it's worth noting the scale and quality of these providers varies. The preferred equity position is typically up to 67% of net asset value, so more leverage.

The preferred equity holder then takes this interest over the portfolio and structures it into a tiered rated note, thereby transforming equity risk into debt. This debt is rated and tradeable, which is great for investment banks. This allows investors such as insurance companies (perhaps owned by the PEAM) to invest into the Class A, B or C parts of the rated note.

There are obviously risks – recession is probably the main one. A serious drop in net asset value (NAV) could erode the value of the layers of finance behind the preferred equity from the top downwards.

While the music keeps playing, these levered structures will offer significant returns to the equity

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holders and offer attractive returns for insurance companies. But one day, the music will stop.

The use of leverage has always been prevalent in private equity but it's becoming more and more complex. Subscription loans, NAV loans, preferred equity, all kinds of fund and even single investor portfolio debt are quite recent additions.

Pushing envelopes

The FT recently outlined the rise of SRTs. Much of this market is designed to enable banks to leverage their balance sheets more aggressively. Alternative asset managers, including PEAMs, are actively buying SRTs from banks, some of which carries the risk of subscription credit lines to the asset managers private equity funds – loans against the private equity fund investor commitments. They are therefore effectively buying the risk on themselves and their investors.

The rise of these levered products, and the increasing interconnections of the large financial institutions, is definitely concerning. It's not completely impossible to imagine some unforeseen chain of events that could put a stop to this party game. Bad actors always exist in financial markets and the PEAMs may not be immune.

Structured debt products can be difficult to understand, and great complexity is easily generated with guarantees, swaps and other derivatives to liven up an offering. I do have some sympathy for the regulators – this stuff is amply complex before any bad actors get involved.

But for now the music is still playing and it's getting louder. Financial history is littered with debt-driven crises.