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How US public funds fuel private equity

By James Politi and Francesco Guerrera in New York

Alan Van Noord, a Pennsylvania civil servant with a laid-back demeanour, makes an unlikely business partner for some of the world's most powerful financiers. Yet, sitting in the spartan state offices, he remembers the day he was too busy to meet Henry Kravis, co-founder of one of the world's most renowned private-equity firms.

Mr Kravis, a dealmaker worth an estimated $2.5bn (£1.3bn, €2bn) whose sprawling New York home was parodied in Tom Wolfe's *Bonfire of the Vanities* , had offered to travel to the sleepy reaches of Harrisburg, Pennsylvania's capital. His aim was to persuade the Public School Employees' Retirement System (PSERS) to invest in the ventures of Kohlberg Kravis Roberts.

"Henry was scheduled to come and it was supposed to be a morning meeting but we had to reschedule," explains Mr Van Noord, PSERS chief investment officer, his words echoing off the bare walls of a meeting room.

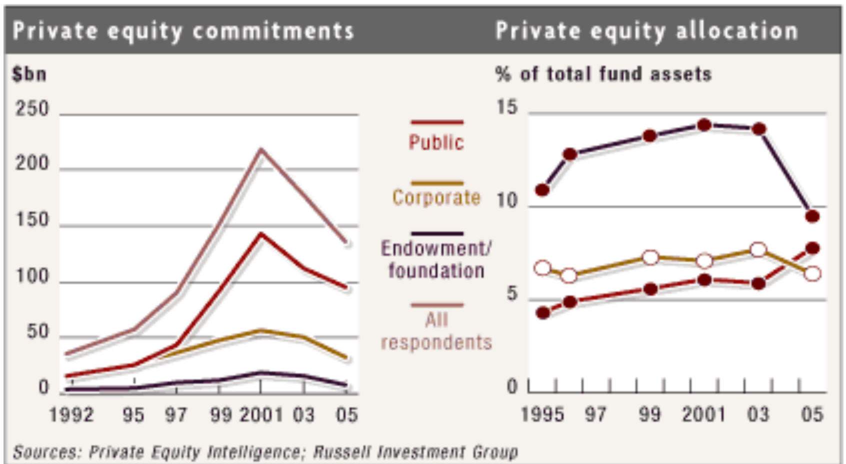
In spite of keeping one of the famous "barbarians" of the financial world outside the gates of Harrisburg, PSERS ended up investing in KKR's latest fund. But the fact that one of private equity's founding fathers would even consider trekking to such a backwater underlines a little-noticed, yet fundamental, trend in global financial markets.

The public funds charged with securing the future of America's pensioners are a crucial driver of the current boom in the private-equity industry. By channelling an increasing portion of the nation's retirement pool into buy-out funds, the public custodians are feeding the cycle of takeovers, restructurings and sell-offs that define private equity.

"We are the big bucks now," says Jay Fewel, an Oregonian who has been running the private-equity division of his state's investment office since 1989. This year, Mr Fewel has already made commitments worth $3.5bn to buy-out firms.

The reason for such huge forays is simple: the successes enjoyed by private-equity firms over the past few years have enabled public pension funds with exposure to the sector to achieve returns far superior to those on equity and bond markets.

In the US pension system, where employees' and employers' contributions rise and fall in roughly inverse proportion to the level of investment gains recorded by public funds, this has translated into windfalls for present and future retirees and lower costs for companies.



For example, the 1.4m members of the California Public Employees' Retirement System, the largest public pension fund in the US, in the last fiscal year reaped a return of more than 19 per cent on the $11.3bn Calpers devoted to private equity from its $211bn portfolio. Over the past 16 years, Calpers has earned 33 per cent more through private equity than if it had invested the same amount in the equity markets.

But with many experts predicting that the boom in private equity will not continue at the heady pace of the past few years, concerns are mounting over the wisdom of such heavy investments by public pension funds.

Should state employees be comfortable with large portions of their retirement savings being invested in a high-risk asset class? Could a bad economic cycle, paired with rising interest rates, lead to a string of bankruptcies that would seriously damage the funds' returns?

At least as worryingly, is a caste system emerging, in which pension funds with a long history in private equity have access to better performing, safer funds while new entrants are left to invest in minor funds with an even greater risk of going bust?

The history behind these questions and the relationship between public pension and private equity begins in the early 1980s – in Oregon. It was there that George Roberts, the "R" in KKR, found the firm's first significant public money backers in Roger Meier and Jim George, the risk-taking duo that ran the state's fund at the time.

Oregon first agreed to back KKR's ultimately unsuccessful attempt to take over a local brewer. Then, more controversially, it injected $176m, or about 8 per cent of its total fund, into KKR's buy-out of Fred Meyer, one of the region's largest supermarket chains.

Had that deal failed, US pension funds might have stayed clear of private equity for decades. But Oregon earned about four times its stake, cementing its relationship with KKR and providing a model for other states to follow.

Since then, public pension funds across America have discovered the allure of private equity. Coupled with the recent development of private-equity "funds of funds" and an increased interest in the asset class by university endowments and wealthy individuals, this pool of liquidity has allowed buy-out groups to raise in excess of $14bn this year alone.

The record fund-raising drives, and the returns enjoyed by the likes of Calpers, have highlighted the benefits of the relationship between retirement plans and private-equity firms. The hard-knuckled world of private equity and the slow-moving bureaucracy that makes up the US pension system may look like an odd couple at first, but they have been brought together by complementary financial needs.

Public funds, with their long-term horizon and little need for trading in and out of investments, are well suited to private-equity firms, whose promise of high returns is conditional on their ability to restructure companies over a number of years before selling them at a profit.

The relationship has worked well. But the record levels of buy-out activity and the unprecedented involvement of public pension funds raise the risk that a lean period in private equity would hit public funds just at a time when many of them are struggling to meet mounting pension obligations. The fear is that, lured by high returns, the guardians of US pensions have got in too deep in assets that are riskier – and more difficult to get out of – than stocks and bonds.

"America's pension funds need to be careful, because private equity is a game for grown-ups," warns Damon Silvers, associate general counsel at the AFL-CIO union federation. "They have to be cautious about asset allocation. There comes a point when there is too much of an asset class, regardless of how good the returns look today."

Public pension funds have nearly doubled their exposure to private equity over the past decade and on average invest some 8 per cent of their funds in the asset class, according to Russell Investment Group, an investor services company. By comparison, corporate pension funds invest less than 7 per cent and their exposure has decreased slightly since 1995.

With rising interest rates lifting the cost of debt used by buy-out groups to fund takeovers and increased competition pushing acquisition prices higher, many pension fund managers admit that returns over the coming years will be eroded. But they claim that the winners will be the investors who have the courage to stay the course when the going gets tough. “In private equity it is very hard to time the market,” says Peter Gilbert, chief investment officer of the State Employees’ Retirement System of Pennsylvania, one of the early investors. “The best results have often come from the worst times, when everybody wants out.”

Indeed, Joe Dear, executive director of the Washington State Investment Board, whose $70bn fund is one of the biggest public investors in private equity, has painful memories of getting out of the sector after a bad spell in the early 1990s. “We were out of the market for about three years and we missed a really good vintage in the venture capital industry as a consequence,” he recalls.

Sticking to private equity when its results begin to fade will require steady nerves on the part of public authorities and strong faith in Mr Kravis and his counterparts at other firms. Unlike listed companies, whose shareholders vet important decisions such as takeovers, investors in private equity delegate these rights to the funds’ managers, who are known as general partners.

Recourse to legal action, so often used by corporate America when business deals go sour, is rarely open to participants in private-equity funds, because the limited legal liability significantly curbs their chances of winning in court.

In a rare case brought against a buy-out fund, the state of Connecticut sued Forstmann Little over two deals to buy minority stakes in telecommunications companies at the height of the technology bubble. Although a jury found against the private-equity group two years ago, the disgruntled state investor was awarded none of the $125m in damages it had claimed.

In spite of the risks, and the obstacles to legal redress, few workers or pensioners question the strategy, partly because they are unaware that such a large portion of their future wealth is tied up in relatively high-risk investments. Certainly, state employees the Financial Times spoke to this month in Salem, Oregon’s capital, had little knowledge of their employer’s exposure.

Among them were Denise, 53, and Miranda, 31 (they declined to give their last names because of restrictions on talking to the media), who work at the Revenue building. Their concerns about their pensions centred instead on a recent decision by the state to stop matching their contributions. Likewise, Paula Wight, 60, a retired elementary school principal in Portland, Oregon's largest city, was worried that too much was being paid out to beneficiaries of the pension system and not enough funnelled into schools. But none knew who Mr Kravis was or what the term "private equity" meant.

One knowledgable, and contrarian, voice in Oregon is Bill Parish, an outspoken investment adviser from Portland often dismissed by critics as a conspiracy theorist. Mr Parish recently attacked the Oregon Investment Council, which oversees the pension fund, for having a "highly speculative investment philosophy that could result in multi-billion-dollar losses and the collapse of the system".

In spite of his strong words, Oregon's trade unions are broadly supportive of the strategy. "The benefit to plan participants has been tremendous. It is hard to fault the council's decisionmaking in this area," says Joe DiNicola, president of the local Service Employees International Union. In some cases, he suggests, there could be strong indirect advantages to having such a close relationship with private equity.

In 2004, when Safeway, the US grocery store chain, was experiencing a protracted strike – one of the longest in US history – Mr DiNicola claims his group was able to help sway the board into offering concessions to the unions because of the state's relationship with KKR's Mr Roberts, who was a director there.

That is disputed by Oregon officials. "We can't dictate any more than any other state how private-equity groups should run their businesses," says Mr Fewel.

Indeed, the power of investors in private-equity funds is very limited and has been shrinking further of late, according to industry participants. With investors eager to offer capital to their funds, private-equity managers have begun imposing tougher conditions on public pension funds.

Lawyers say that private-equity firms have been demanding stricter rules to prevent public funds revealing details of their investments and performance. At the same time, they have fought demands for greater accountability and transparency.

Investor requests that private-equity managers put a larger portion of their own personal wealth in the funds – a widely used way of ensuring that the remuneration of managers is linked to their funds' performance – are now routinely rebuffed. Mr Van Noord's PSERS recently relaxed rules that restricted it to funds whose general partners contributed at least 5 per cent of the total – a requirement described by a Boston-based private-equity lawyer as “a frequent deal-breaker and a persistent pain”.

But the biggest risk is arguably inexperience. Unlike stock and bond market funds, the divergence between private-equity top performers and also-rans is vast – making it vital to invest in the right fund. This is particularly tricky for state funds that have not invested in private equity but are now attempting to share in the industry’s high returns – such as in Arizona, New Jersey and North Carolina.

Traditional investors, such as Oregon and Washington, are usually offered first pick and sometimes better terms when big buy-out groups raise funds, restricting access for other states to top firms such as KKR, Blackstone, Bain or Texas Pacific Group.

James Nielsen, chief investment officer for the Arizona Public Safety Personnel Retirement System, says his fund will allocate only about 2–3 per cent to private equity: “Getting access to the top-tier funds is a little more difficult for a fund like us. That’s why we are going in judiciously.”

For those who do not tread as carefully, the consequences of investing a lot in poorer performing funds, and at what many observers view as near the peak of the market, could be dire. Even Calpers, an early investor in private equity and a fund that by virtue of its size and pedigree can get access to the best deals, is moving to halve the number of firms it deals with to about 70.

“This is an industry where the top funds significantly outperform the others. We are trying to raise the bar and to differentiate who is out there,” says Joncarlo Mark, Calpers’ senior portfolio manager. Otherwise, he adds, “one risks being relegated to the ranks of the underperformers”.

So far there have been few embarrassments. The biggest was probably last year, when it emerged that an Ohio state pension fund had invested in a high-risk rare coin venture that went sour, leading to pressure on Ohio to begin disclosing the performance of its investments, down to individual portfolio constituents.

In Oregon, a difficult moment came in 2004 when Texas Pacific Group was trying to buy Portland General Electric, the local utility, but was eventually rebuffed by state regulators. Their worry was that too much debt would be applied to the business and that TPG would not significantly cut users’ bills.

The experience did not ruin the relationship between the buy-out group and the Oregon treasury – although TPG received only a relatively modest $300m from the state in its latest fund-raising.

But as pension funds increase their allocations to risky investments, and buy-out groups do increasingly daring deals around the world, the strange tango between figures such as Mr Van Noord and Mr Kravis is likely to become ever more precarious.

On offer in Salem are a sandwich and sanity

When the glitzy world of Wall Street crosses paths with public administration, there is inevitably a contrast in styles. But few could be as extreme as when private-equity executives fly in to small state capitals to raise money for their multibillion-dollar funds.

"Clearly they are in a different economic stratum: they have limousines waiting to pick them up from meetings – and we cringe at paying three bucks for our lattes," says Ron Schmitz, Oregon's tall, heavy-set chief investment officer. "They are pretty good about not rubbing it in and we do get treated like peers," adds Mr Schmitz, who took the post in 2003 after running funds for Illinois and Blue Cross/Blue Shield, the health insurer.

The annual budget for Mr Schmitz's division is $3.2m (£1.7m, €2.5m): that includes its share of the rent in Salem's Labor & Industries building, a small travel budget and, accounting for more than half the pie, a dozen staff salaries.

According to one private-equity headhunter, the entire budget of Oregon's investment office is at the lower end of what a senior partner at a large buy-out shop might expect to make in a year – even before any share of the profit from deals is doled out.

Only two staff help Mr Schmitz decide which investments in private equity Oregon should be making. One is Jay Fewel, a 17-year veteran of the fund with greying temples and a passion for fishing. The junior team member is Wei Huang, a former fund-of-funds manager from Morgan Stanley and Citigroup in New York who took a hefty pay cut when he moved to Oregon last year, for family reasons and a change of pace.

The three live in Portland or in a quiet suburb called Lake Oswego that embodies many of the region's attractions: it offers the water and lots of greenery. Yet it is a far cry from what private-equity specialists can aspire to in terms of glamour, excitement and high living.

Instead of the bison carpaccio and summer black truffles on offer at the Four Seasons, a Manhattan venue frequented for lunch by partners of firms such as Blackstone, the canteen in the basement of Salem's L&I building is where Mr Schmitz and Mr Fewel usually take their repast of sandwich or salad.

Still, pension fund staff can share some of the perks of proximity to the new kings of Wall Street. In Oregon, they are allowed to accept a meal from a buy-out executive no matter how expensive it is, as long as the two sides eat together.

But stern restrictions govern other forms of leisure or entertainment. In most cases, after a $100 cap on spending has been reached, Oregon staff need to pay out of their own pocket. For such reasons the ability to attract and retain talent is one of the harder tasks for directors of public-pension fund investment programmes.

Mr Schmitz scored a victory recently when the Oregon legislature approved paying bonuses to his team. This will help his plan to hire someone to oversee private-equity holdings – and could prove even more precious should the Oregon Investment Council put money into hedge funds as well.

But, otherwise, there is little more to offer than an appeal to public service – and a life closer to nature. Asked how the team goes about recruiting, Mr Fewel answers with a laugh: "I take them hunting and fishing."

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