PRIVATE EQUITY manager
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Pinching pennies

When it comes to hiring, private equity firms will be looking to make more out of less in the next few years. By Tom Bonney of CMF Associates

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During a recent, reminiscent listen to Kansas' 1976 hit, "Carry on Wayward Son," it struck me that a 2009 rendition of this song would describe quite the opposite dynamic. Over the past year, the economic "carry" did not carry on, as evidenced by a recent PEI study of middle-market private equity funds that revealed 75 percent did not distribute a carry in 2009.

In addition, current income into many private equity fund management companies is down significantly, due to lower transaction fees that are the by-product of lower transaction volumes and increased overall pressure from limited partners on fees related to the percent of assets under management.

The current lacklustre state of carry and income holds significant implications for private equity employment opportunities and management environments in 2010, particularly at the principal, vice president and analyst levels. Key projections include mid-level management departures from private equity for current income or unfunded sponsor opportunities; hires of cost-effective younger talent; investments in outside talent resources; and a leaner, performance-centred fund management structure that could impact overall compensation and employment demand in the sector.

Talent movement

Over the past 10 years, mid-market fund growth enabled new MBAs to readily launch a private equity career right out of grad school, work hard to ultimately get promoted to managing director, and make significant money from their share of carried interest. This professional growth scenario is not the norm today, with fund size growth essentially stagnant, and many firms either under water on their current fund and/or unable to raise new funds. As a result, many mid-level private equity professionals are poised to seek employment elsewhere, with the objective to find current income instead of hoping for enough capital gains from stabilised portfolio companies to put their carry in the black, or patiently waiting for a subsequent fund (which may or may not be possible given the climate) to re-start the five-to seven-year investment cycle.

Other mid-level management departures from muted funds may occur as private equity professionals opt to strike out on their own as unfunded sponsors, and leverage skills and relationships in order to get their own deals done. Furthermore, 2010 and 2011 could be years where the "good deal" is in short supply and difficult to coax out, opening the door for the unfunded sponsor to provide notable value to the marketplace. Critical to the appeal of this career transition path is the fact that the unfunded sponsor will not have to first earn back losses in previous deals.

Hiring activity at private equity funds will likely focus on the addition of younger, cost-effective talent to manage the projected uptick in deal volume from 2009 levels. As noted above, management company cash flow is expected to be tight, but could be tempered with an expected rise in transaction volume, both in acquisitions of new platforms and in bolt-on acquisitions to "dollar cost average" a platform acquisition into higher returns. Funds' orientation toward the hiring of lower-priced, raw talent recently out of school is evidenced by the following excerpt from a recent fund employment advertisement: "Highest level work effort and dedication required – expectation of 70-80 hours per week . . . compensation offered will be a base of $50,000 with a potential maximum annual bonus of $20,000 depending on performance."

Alternatively, more funds could turn to outsourced talent for management of specific components of the deal process (deal sourcing, analysis, deal close management, etc.), that could be paid for directly by the portfolio company or written off as a deal expense, preserving the finite supply of management fee dollars. Notably, the investment in third-party resources related to providing restructuring, turnaround, and operating support for struggling portfolio companies could have been an additional factor in the sluggish private equity hiring pace seen in 2009.

Bill Lehr, managing director at unfunded sponsor Paxinosa Ventures and formerly a vice president at Blue Point Capital, notes, "I feel it's an opportune time to start Paxinosa. Owners of small- and medium-sized businesses are showing renewed interest in discussing alternatives including complete sales, capital raises and minority recaps."

Management models

Shifts in the private equity management model toward heightened performance incentives and a leaner organisational structure could result in increases in individual compensation over the long run, which could be balanced by narrower overall availability of PE fund management team positions.

Changes in long-term compensation could stem from limited partners' awareness that the "carry" is significantly under water, much like management options in public companies. Limited partners could face decisions around the re-pricing of the carry for key managing directors and others; private equity funds with a good story and strong management team could conceivably request a positive adjustment to the current pay-versus-carry formula to incentivise the team to stretch as hard and as far as possible to optimise a fund's return.

Fewer overall employment opportunities within funds could be the ultimate offshoot of the squeeze on mid-market private equity. Because investment theses, financing structures, deal components and other pre- and post-closing issues are now well known to the cadre of bankers, lawyers, accountants, and consultants who work in the industry, there will no doubt be some talent-related adjustment to the overall business model and management of private equity. However, this change will occur slowly, over time and without much fanfare.

While deal volume is expected to increase in 2010, an uptick will not necessarily translate immediately into increased demand for talent at funds. Rather, hiring at private equity tends to be tied to fund raising, a pursuit that will likely remain challenging until well after the deal market rebounds.

The closing lyrics of "Carry on Wayward Son" include, "On a stormy sea of moving emotion/ Tossed about I'm like a ship on the ocean/I set a course for winds of fortune/But I hear the voices say." As we turn the page on 2009's negative carry and income trends, and enter projected clearer skies and smoother sailing in 2010, there is a potential that the nature and extent of the hands on deck at private equity funds will change as we make the necessary course corrections to safely get the ships into port.