



Daily comment

Wanted: only responsible firms need apply for money

James Mawson

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The industry is on notice to behave more responsibly, and rightly so.

AlpInvest Partners, in a guest comment this week, sensibly calls for self-regulation and action on transparency and environmental and social guidelines.

To an industry that seems to reward executives that strike and then exit the deals, these issues can be seen as a sideline, at best. However, there is a growing consensus among the people who matter – the limited partners – that it is important. This will shift sentiment among general partners.

A host of firms – Actis, 3i, Doughty Hanson, KKR and many others covered in previous issues of Private Equity News – have started to respond as hoped for and hired people to oversee the issues or signed up to the United Nations Principles for Responsible Investment.

The reluctance of a few firms to take these issues seriously risks the reputation of all. The only solution is to endorse the comment of Wim Borgdorff, a managing partner at AlpInvest, that enforcing these ideas should not be left to a paper tiger. This will require there to be serious consequences – and not just from a trade body which will struggle to influence firms. It is down to the limited partners to show they are prepared to walk away from firms, even from some top-quartile names if necessary.

When asked, Borgdorff said this was a logical conclusion to AlpInvest's work in this area. He said: "In line with PRI principles, we focus on engaging, disclosure and transparency first. We will investigate GP CSR [corporate social responsibility] status against the UN global compact guidelines. Over time, we expect the PRI principles to develop towards a more compliance-based approach."

Firms have been duly warned, but the issue is coming to a head at a sensitive time. Private equity firms are being caught in a US investigation into allegedly suspect payments to placement agents to get access to public pension funds. Firms have rightly distanced themselves from anything that might seem even slightly suspect and there seems little overspill to other countries – at least so far.

The industry has an admirable reputation for correcting agency problems seen in public markets and delivering a better and more aligned system of returns and rewards than almost all other parts of the financial services sector.

There are still flaws, however, and potential abuses of power and suspect payments should be rooted out. A complacent attitude has built up about how much better private equity is than other industries.

In a fascinating research paper published last week in the Northwestern Journal of International Law and Business, Douglas Cumming at York University and Andrey Gill and Uwe Walz at Goethe University said there was "significant reporting biases" in overstating the value of portfolio companies to LPs.

The art of valuation by many firms, particularly in the US, is failing to meet the basic test of a leveraged portfolio company when the market is down and prices are falling, ie many buyouts are worth nothing. The paper points out the obvious – that LPs should not put too much weight on the unrealised values and should pay performance fees only on cash-on-cash results. But a drip-drip of shaky looking accounts is corrosive to trust more generally. Now is the time for the industry to step up to the challenge.

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