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Outlook for 2017

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The year ahead

Chris Meads, Head of Investment

Coming so soon after an extensive paper on the implications of Donald Trump's unexpected victory in the 2016 US Presidential elections[1], I must admit I was a little stuck with how to approach this year's Outlook for Private Equity. The populist wave crashing over the shores of the US and Europe still has much more to run, and whereas in the past we didn't need to devote so much attention to the political environment in forming a view on private equity, unfortunately I see these epochal changes having a lasting impact on our industry.

To date, not much has changed since my earlier piece on Donald Trump, aside from the fact that in announcing his nominations for cabinet positions, President-elect Trump has reinforced my expectation that he intends to unleash an ambitious agenda for change, perhaps even radical change, in US tax, healthcare, foreign trade, and infrastructure policy.

Instead of the usual survey of the outlook for economies, markets and private equity over the coming year, I've chosen to adopt a more thematic approach to this year's Outlook, and have split the document into four key topics. First is a discussion of the lessons from history on how financial crises can have lasting political ramifications. After such a gentle warm up, we then move into the 'meat and potatoes' part of the essay; first up is an outlook for corporate tax reform under the Trump administration, in particular focusing on the implications of possible changes in US corporate tax policy for the US buyout industry. Next is a response to the proposition that growing investor interest in the asset class will drive down PE returns, which after all is what we're here for. Finally, we end with some comments from our guest contributor, who comes from the opposite side of the aisle to me, shall we say.

[1] Pantheon Infocus, "A Trump White House: What Does it Mean?", November 2016

A brief history lesson

In my previous paper on President-elect Donald Trump, I made the point that in the aftermath of both Brexit and Donald Trump's election victory, and now with the Italian referendum result and the resignation of Matteo Renzi, we were still living through the reverberations of the 2008 global financial crisis. It is interesting that when commentators look for analogies to the 2008 crisis, they typically go directly to the Great Depression (1929-39) and look for similarities or differences in our more recent experience compared with the third decade of the 20th century. However, and I am indebted to an article by Niall Ferguson for this insight[2], I believe there is a much closer analogy for recent events in a much earlier and lesser known financial crisis; namely the Panic of 1873.

The Panic of 1873 was a financial crisis spawned in the US that triggered what is generally regarded as the first global economic depression, from 1873 to 1880, in the history of modern financial capitalism. As often happens with global financial crises, the trigger for the Panic of 1873 was a specific local event, namely a labyrinthine financial scheme hatched by Jay Gould and fellow investors to support the value of their US railway investments. When the inevitable happened and Gould's bank eventually declared bankruptcy weighed down by worthless railway bonds, financial market panic ensued. Without an established Central Bank in the US to calm markets, Cornelius Vanderbilt stepped in to provide liquidity, effectively a precursor to J.P. Morgan's similar actions during the Panic of 1907, and continuing right down to this day to the extraordinary quantitative easing measures undertaken by major global central banks. Vanderbilt himself was under no illusions regarding the fundamental cause of the panic:

> "I'll tell you what's the matter – people undertake to do about four times as much business as they can legitimately undertake. . . . There are a great many worthless railroads started in this country without the means to carry them through. Respectable banking houses in New York, so called, make themselves agents for sale of the bonds of the railroads in question and give a kind of moral guarantee of their genuineness. The bonds soon reach Europe and the markets of their commercial centers, from the character of the endorsers, are soon flooded with them. . . .
>
> When I have some money I buy railway stock or something else, but I don't buy on credit. I pay for what I get. People who live too much on credit generally get brought up with a round turn in the long run. The Wall street averages ruin many a man there, and is like faro[3]."

[2] http://www.niallferguson.com/journalism/finance-economics/an-interview-with-niall-ferguson

[3] Cornelius Vanderbilt, quoted in "The First Tycoon". T.J Styles (2009), pp. 536-537.

Substitute the words, ‘housing’ and ‘subprime loans’ for ‘railroads’ and ‘bonds’, and the Commodore’s description of the root cause for the Panic of 1873 could equally well apply to the 2008 global financial crisis.

Then as now, panic quickly spread to offshore financial centers. After Germany’s victory against France in the War of 1870 and the creation of the German empire in 1870-71, there followed a brief but spectacular period of significant financial innovation in Germany coinciding with rapid industrialization. However, this progress all came to a crashing halt when financial panic swept into Germany from the US. Faced with surplus American and Russian grain flooding into the German market, agricultural prices collapsed threatening the deeply indebted Junker land-owning elite. German national production is estimated to have declined for six successive years from 1873. This in turn triggered a burst of emigration from depressed rural German provinces to North and South America[4]. While the resemblance of certain aspects of modern financial era to the Panic of 1873 are striking, so too are the ironies.

After forming a new alliance with conservative political parties, Chancellor Otto von Bismark initiated a significant change in German economic policy in 1878-79 in response to the depression. Tariffs were introduced on imports of iron and major agricultural grains. Tariffs on the latter were raised further in 1885 and again in 1887. German railroads were nationalized and, for the first time globally, compulsory insurance for sickness, accidents, old age and disability were introduced in Germany in stages from 1883 to 1889. State sponsored cartel agreements apportioned markets, set standards and fixed prices for steel, coal, glass, cement, potash and chemicals.

By veering away from classical liberal economic policies, Bismark boosted the fortunes of the German economy, and his policies were in turn mimicked by other major European countries, notably France, which also imposed tariffs on a range of agricultural and industrial imports in 1880 and 1892. Only Britain, among major global economies of the day, held out against the wave of global protectionism during this period, and forced its domestic firms to cope with more competitive imports by reducing costs or going out of business. But in so doing, the ratio of British investment to estimated national output halved from 1873 to 1896, whereas it increased by around 50% in Germany over the same period[5]. Germany chose to stimulate demand and expand industrial capacity by promoting investment whereas Britain chose a form of economic policy that sounds remarkably similar to today’s austerity economics.

Whereas Bismark’s policies generally worked in reviving Germany from the effects of economic depression set off by the Panic of 1873, the effects on political development in Germany were nowhere near as benign. By insulating them from the vagaries of international markets, the grain tariffs revived the fortunes of conservative German land owners, who then set about thwarting further political liberalization in Germany. Then, as now, the principal targets of populist leaders were immigrants and free trade. During this period the US passed laws restricting Chinese immigration. Germany and France moved further towards anti-Semitism and Victorian Britain persecuted the Irish.

What began as an arcane financial speculation in New York led inexorably to the decline of liberal political development across Western Europe in the two decades following the Panic of 1873. One need only look at the current travails of Brexit-Britain and post-referendum Italy and look forward to elections in France and Germany next year to see that Mark Twain’s aphorism about history rhyming still holds remarkably true.

[4] https://www.britannica.com/place/Germany/Germany-from-1871-to-1918

[5] Park, Young Goo (1997), “Depression and Capital Formation: The United Kingdom and Germany, 1873-96”, Journal of European Economic History, 26(3), 511-534.

President-elect[6] Donald J. Trump's plans for US Corporate Tax

Wading through press releases and position papers hunting for clues on tax reform is never much fun. However, with the new Trump administration looming ever closer, there is one particular aspect of both President Trump's and the Republican legislature's proposals for tax reform that deserves greater attention than it has so far received from US Private Equity investors.

Let's start with the Republican legislature. In February 2016, House Speaker Paul Ryan announced the creation of six task forces that would develop detailed policy recommendations to "serve as the pillars of our pro-growth plan for the future – our plan for a confident America[7]." The Tax Reform Task Force, led by House Ways and Means Committee chairman Kevin Brady (R-TX), is the one to focus on here. The goal of this particular task force "was to deliver a strategy to create jobs, grow the economy, and raise wages by reducing rates, removing special interest carve-outs, and making our broken tax code simpler and fairer[8]." The task force report was released in June 2016.

Here are the salient points from the House Republican's tax reform plan worth noting in this context:

> Corporate tax rates would be lowered to a flat rate of 20% compared with the current rate of 35%. The corporate alternative minimum tax of 20% would be repealed.

> All US businesses would be allowed to claim a full and immediate tax write-off for their investments in tangible and intangible assets, excluding land purchases.

> Corporate tax deductions on net interest expense would no longer be allowed. "Job creators" would be allowed to deduct interest expense from interest income in calculating their tax liability, and net interest expense could be carried forward indefinitely as a deduction against net interest income in future years. The Committee on Ways and Means would be tasked with developing special rules in respect of interest expense for financial service companies, such as banks, insurance and leasing, to take account of the role of interest income and expense in their business models.

> The current worldwide tax system of American companies would be replaced with a territorial approach to taxation effectively allowing 100% exemption for dividends from foreign subsidiaries' earnings. Accumulated foreign earnings would be subject to tax at 8.75% if held in cash or cash-equivalents, and otherwise would be taxed at 3.5%, with US companies able to pay the resulting tax liability over an eight-year period.

[6] Henceforth, for brevity's sake, I refer to President-elect Donald Trump as simply President Donald Trump.
[7] "A Better Way, Our Vision for a Confident America: Tax," June 24, 2016. http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf
[8] Ibid.

Comments on the House Republican's tax reform plan

The removal of the tax deductibility for interest expenses would have a serious impact on the cash-flow characteristics for companies acquired by US buyout fund managers, given the amount of debt normally used to finance the acquisition of these companies. The tax force report is silent on whether this change would only affect new business loans or would also apply to current loans. The exemption whereby interest expenses can be offset against interest income is unlikely to provide significant relief to companies owned by buyout funds, as these companies do not usually hold significant surplus cash, and therefore are unlikely to consistently generate meaningful interest income. Furthermore, the qualification for this exemption (i.e. that the company be "creating jobs") is not clearly defined in the document.

In mitigation of the House Republican's tax plans, the lower corporate tax rate would reduce the cost of equity on new deals. Allowing tax deductibility for investment expenditure would shift the tax advantages away from the method of financing (i.e. away from debt) and towards a particular component of business expenditure (namely new investment). Ironically, this change could hasten the move towards greater automation in the US workplace implying that its effect on US job creation might be rather muted or possibly even negative. To make the most of the lower corporate tax rate, buyout managers would have a greater incentive to use more equity in purchasing profitable American businesses requiring significant new investment to finance future growth. The line between buyouts and growth investing would likely become more blurred.

There are some features of the plan that, unless changed, would create a significant loophole in respect of the tax treatment of interest expenses. In particular, with the proposed move to territorial taxation of US companies, it is not hard to imagine a multinational US company choosing to employ greater debt financing in those offshore jurisdictions that still allowed tax deductibility for interest expenses, while at the same time employing more equity financing in the domestic US market to finance new investment expenditure. Assuming the foreign borrowing is routed by foreign banks, this would effectively off-shore the financial risk of greater corporate borrowing while on-shoring new investment – I wonder if the House Republicans intended things to be that way? If this policy became law in the US, one could also imagine a wave of similar tax changes being adopted in offshore jurisdictions to counteract exactly such tax-driven financial planning and investment-switching behavior.

Furthermore, the introduction of the House Ways and Means Committee to develop rules for "financial businesses" raises another possible line of attack for the lobbying efforts of the US private equity industry in seeking an exemption from the change in the treatment of interest expense.

So where does President Trump sit on US company tax reform and how might it impact US buyout managers? In two speeches on August 8th (to the Detroit Economic Club)[9] and September 15th (to the New York Economic Club)[10], President Trump made similar references to the to a full and immediate tax write-off for new investment in tangible and intangible assets, excluding land. However, by the time of the second speech in New York, this proposal had been refined to indicate that it would

[9] https://www.donaldjtrump.com/press-releases/an-america-first-economic-plan-winning-the-global-competition
[10] https://www.donaldjtrump.com/press-releases/trump-delivers-speech-on-jobs-at-new-york-economic-club

apply only to US-based manufacturers. President Trump went further in his proposal on corporate tax, proposing that it be lowered to 15%, but he slightly tweaked the taxation of offshore earnings relative to the House Republicans' proposal, proposing a deemed repatriation of corporate profits held offshore at a one-time tax rate of 10%. Finally, in his published tax plan, President Trump clarified his proposal for the treatment of tax on interest expense as follows (repeated in full with emphasis added here for clarity):

> **Firms engaged in manufacturing in the US may elect to expense capital investment and lose the deductibility of corporate interest expense.** An election once made can only be revoked within the first 3 years of election; if revoked, returns for prior years would need to be amended to show revised status. After 3 years, election is irrevocable[11].

In contrast to the House Republicans' plan, President Trump has proposed restricting the tax write-off for new investment expenditure to just those firms engaged in US manufacturing; he has made those firms choosing to do so give up their tax deduction on interest expenses; he has made explicit that such an election is voluntary; and finally he has not said that firms outside of the US manufacturing sector would also lose their tax shield on interest expense.

Leaving aside the affordability (or lack thereof) and income distribution consequences of President Trump's tax policy[12], his proposal for the tax treatment of interest expenses is clearly more favorable for the US private equity industry than the earlier one put forward by the House Republicans. Perhaps this is not terribly surprising given his own prior history of utilizing this particular tax shield, nor for that matter those of some of his most prominent advisors in this area, including Wilbur Ross, founder of WL Ross & Co. and President Trump's nominee for Secretary of Commerce, as well as Stephen Schwarzman, Chairman and CEO of the Blackstone Group, who will chair of the President's Strategic and Policy Forum.

The House Republicans' plan to allow the immediate expensing of business investment was, in their own words, "a more beneficial and more neutral substitute for the deduction of interest expense associated with debt incurred to finance such investment[13]." By linking the source of financing and the use of proceeds for investment, President Trump's proposal more immediately tackles the issue addressed by the House Republicans. I cannot say that the restrictiveness of President Trump's policy to just the manufacturing sector is anywhere near as sensible. In what ways are investments made within the US telecommunications, IT and healthcare sectors (to name just a few) not equally deserving of such tax treatment? I think that the lesson from all this is that we should remain vigilant on how the incoming Trump administration and the House Republicans interact in future months in trying to achieve some consensus on US corporate tax reform.

[11] https://www.donaldjtrump.com/policies/tax-plan/
[12] For further comment, please refer to Pantheon's recent Infocus "A Trump White House: What Does it Mean?"
[13] Ibid.

Why invest in Private Equity?

Steven Kaplan is the Neubauer Family Distinguished Service Professor of Entrepreneurship and Finance at the Chicago Booth School of Business. Professor Kaplan has published an extensive range of articles on private equity, venture capital, entrepreneurial finance, corporate governance and corporate finance - so many in fact that his CV lists over four pages of publications on these topics[14]. So when someone as knowledgeable on the topic of private equity as Professor Kaplan suggests that investors should be contrarian in their private equity allocations because of a negative relationship between capital flows and returns[15], we should pay attention, shouldn't we?

Professor Kaplan argues that a major driver of the performance premium that private equity generates relative to public markets is due to the existence of an illiquidity premium. The idea is that because investors are locking up their money in private equity funds for a long time, and therefore cannot readily liquidate their private equity investments to meet unexpected financial demands, or can do so only with high transaction costs, they should be rewarded for that risk. I have no argument with that claim. Cambridge Associates report that their US Private Equity index has outperformed the S&P 500 index over a 25 year period by an average 504 basis points per annum ("p.a.")[16]. It seems entirely reasonable to me that some part of that average outperformance, and possibly even a major part of it, represents a fair return for the risk the investor takes due to the illiquid nature of their private equity investments.

However, that doesn't necessarily imply that investors should attempt to be contrarian in their allocations to private equity as an asset class in its entirety.

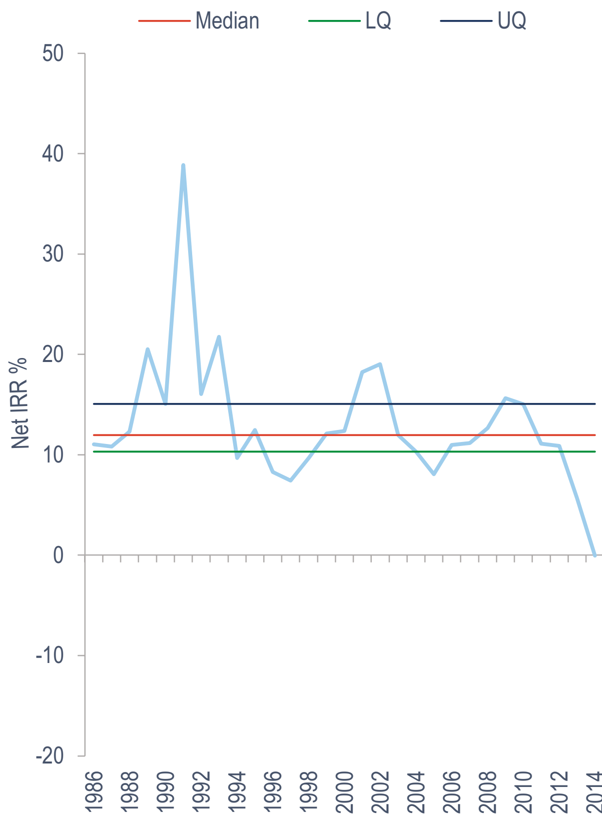
Professor Kaplan's argument for being a contrarian allocator to private equity revolves around the competitive dynamics of the private equity deal market. His argument is that when private equity funds as a group raise lots of money in a particular time period, they all end up competing for similar deals thus lowering returns relative to a situation of less competition. Essentially, Professor Kaplan argues that the illiquidity premium for private equity fluctuates based on the level of competition in the private equity market. Once again, this seems an entirely reasonable argument. Where I do differ from Professor Kaplan however, is whether investors in private equity funds should try and compensate for these fluctuations in average returns for the asset class as a whole by varying the amount they commit to private equity compared with other asset classes. Here's why I think this.

Cambridge Associates have published the aggregate performance of US Private Equity funds included in their database for vintage years covering the period 1986 to 2014. We plot the median performance for funds in each vintage year in Figure 1. Note that these are net returns to limited partners. In this chart we show the median of the entire range of fund vintages, 12.0% (red line), and the top and bottom quartiles, once again over the range of fund vintages, 15.1% (navy line) and 10.3% (green

[14] https://www.chicagobooth.edu/faculty/directory/k/steven-neil-kaplan
[15] See for example, http://www.top1000funds.com/featured-homepage-posts/2016/01/13/what-is-an-adequate-premium-for-private-equity/
[16] See U.S Private Equity Index® and Selected Benchmark Statistics, June 30, 2016 downloaded from https://www.cambridgeassociates.com/our-insights/ on 7 December 2016.

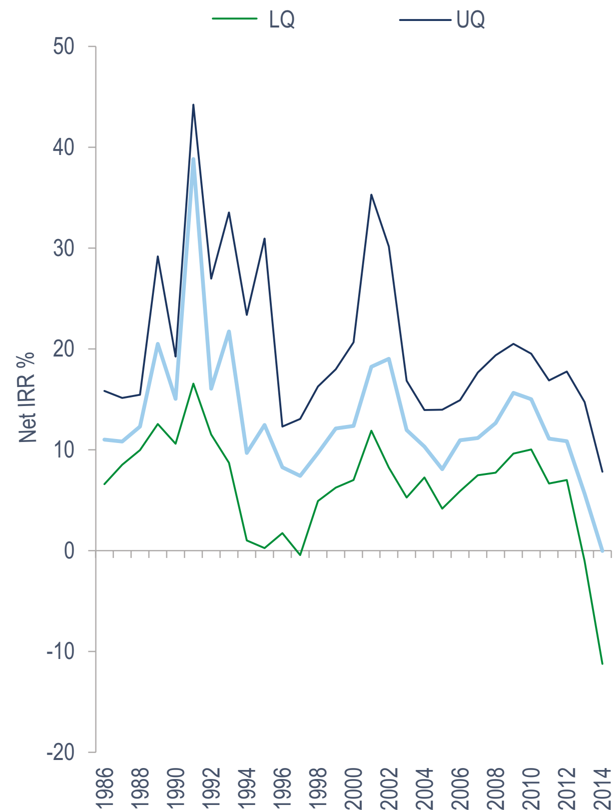
Past performance is not necessarily indicative of future results. Future performance is not guaranteed and a loss of principal may occur.

Figure 1. U.S. Private Equity: Since Inception IRR by Fund Vintage Year | Median and Quartile Performance over time



Source: Cambridge Associates

Figure 2. U.S. Private Equity: Since Inception IRR by Fund Vintage Year | Median and Quartile Performance in each vintage



Source: Cambridge Associates

line), respectively. While the absolute range of returns across vintage years is fairly high, from -0.4% to 38.9%, half the vintage years from 1986 to 2014 had median returns clustered in a fairly tight range of 475bp, i.e. the difference between the top and bottom quartiles across fund vintages.

We now compare this picture with the top and bottom quartile returns from the same data set, within each particular vintage year in Figure 2. The blue line, representing median performance is unchanged from Figure 1, but now the upper and lower quartile lines represent the spread of performance across funds within the same vintage year.

Comparing Figure 1 and 2, the difference in fund performance is greater for funds within a particular vintage year, than it is across vintage years. In fact, it's not even close. Within any given vintage year chosen at random from this sample, the middle 50% of funds

[30] Source: Nasdaq Commodities Market, Crude Oil Brent. Price for Brent was $36.89 a barrel on January 4, 2016.

(i.e. the difference between first and third quartile funds) differed in their performance by an average 1,410bp p.a. The inter-quartile range for fund performance in the Cambridge Associates sample for any given vintage year hit an all-time low of 549bp in 1988. This is still higher than the inter-quartile range of performance across vintage years of 475bp.

So how do these observations tie into whether we should try and be a contrarian allocator to private equity? A decent proxy for the likely performance benefit of following a contrarian approach to private equity allocations is the inter-quartile range **across** vintages. For half of the vintages from 1986 to 2014, US private equity performance was in the range of 10-15% p.a. and in only 25% of cases was it less than 10%. While choosing the wrong vintage would have hurt an investor's performance somewhat over this period, choosing the wrong funds even in the best year would have hurt investors even more. For example, the data for US private equity performance from Cambridge Associate shows that 1991 was a particularly good vintage with median fund performance of 38.9% p.a. However, 3rd quartile funds raised in 1991 only delivered a net IRR of 16.6% p.a. In contrast, the worst performance by upper quartile funds across the entire 1986 to 2014 period was in 2014 (7.8% p.a.) and second worst was in 1996 (12.3% p.a.). The 2014 funds are possibly still suffering j-curve effects and might therefore improve their performance in future years, but the performance of the 1996 funds is fairly well baked in and is unlikely to change much in future years. Interestingly the Cambridge Associates benchmark performance of the S&P 500[17] for the 1996 vintage was 4.8% p.a.

The moral of the story is that being a contrarian asset allocator in private equity wouldn't have helped much if you chose the wrong US private equity funds over this period. In contrast, an investor who was unlucky enough to choose 1996 to make their US private equity commitments but who was either skilled enough to choose top quartile funds, or possibly outsourced that selection to someone who was skilled, still experienced significant outperformance relative to public markets and credible absolute performance even in a comparatively poor performing vintage.

Private equity is an inherently active style of investment. There is no "index tracker fund" available for private equity that would allow investors to passively earn the median return for the asset class as a whole. If there were, then Professor Kaplan's comments would have more relevance. Short of that, investors must choose which funds to invest in, assuming they can secure an allocation to their desired funds. The risk/reward tradeoff for fund selection drowns out inter-vintage fluctuations for returns from the private equity asset class as a whole.

[17] Benchmark performance of the S&P 500 index is constructed by Cambridge Associates using the Modified PME method. Ibid.

And finally… Eric Cantor's perspective on the election of Donald Trump to the US Presidency

Those of you who joined us at our Annual Investor meeting in New York in June 2016, and in particular those who attended Eric Cantor's speech will recall his fascinating insights into the US political scene and his outlook for the US Presidential elections. As a reminder, Eric Cantor was US representative for Virginia's 7th congressional district from 2001 to 2014, and served as House Majority Leader from 2011 until losing a primary contest in his home congressional district in 2014 to a Tea Party candidate. As such, Eric is uniquely qualified to talk about both the inner workings of the US legislature as well as the development of the modern US Republican party. While Eric was predicting that Hillary Clinton would win the US presidential elections when he spoke to us in June (who wasn't?), we felt that it would be interesting to canvass his views on the likely outlook for US politics following the shock Trump victory.

> "Big things, like tax reform and healthcare reform, will get done over the next two years. In part because with unified control Republicans have an obligation to govern and no one to blame for not getting things done."

> "In addition to tax and health care reform, issues to watch include regulations (especially environmental and financial), infrastructure (what does the President intend to pursue and how will Congressional Republicans react), trade, and immigration."

These comments coincide with the comments I made in my earlier essay on President-elect Trump highlighting tax, healthcare and financial sector reform as areas of focus for the incoming administration during the early part of Donald Trump's presidency. However, the process won't be easy according to Eric, with Democrats likely to take a deliberately obstructionist approach to many aspects of the Trump reform agenda:

> "That said, action will not be nearly as swift or as painless as many predict. Legislating is a hard, ugly process and there will be times when it looks like things are about to collapse. We also shouldn't forget that just as some on the right challenged in court the legality of Obama's executive actions, there will be those on the left who will head to court to challenge Trump's new actions and rulemakings."

Reflecting the exuberant mood of equity markets in the wake of the Trump victory, Eric expects a more business-friendly White House, at least in the short run:

> Unified Republican government will be much more active than the divided government of the last six years, and we can expect it to be much more business friendly than the unified Democrat government of 2009-2010. This is reflected in the market reaction post-election. That said, Trump is not an ideologue and his agenda will be a mix of traditional Republican positions and a more populist, economic nationalism. Predicting how this Administration will react to things will be much more difficult than predicting the actions of prior Administrations.

And finally, reflecting Trump's apparent willingness to use the Presidential foghorn to bully US companies into bending to his agenda, Eric foresees a radically new way of the Trump White House interacting with the commercial sector. Carrier, Boeing, Lockheed-Martin have recently felt the lash of Trump's rhetoric even before he has taken office:

> As we have already seen, the President-elect is willing to wade into and comment on issues that traditionally presidents have refrained from engaging on. While we don't know exactly how this will play out once Trump is sworn in, business leaders must assume that the way they engage and are engaged by Washington will be totally different from what they have experienced before.

In summary, the implications of the ascendency of President Trump to office continue to reverberate throughout financial markets, the US economy, and the world at large. No doubt there will be much more to come on this topic in the year ahead.

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