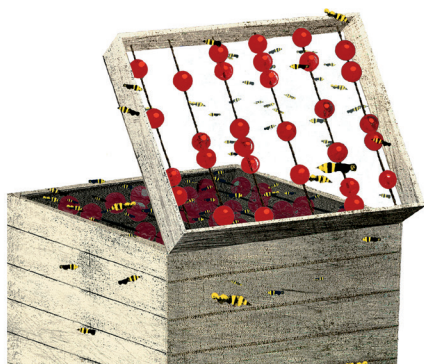


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PRIVATE EQUITY (GLOBAL)

A conversation with Jim Coulter

The veteran investor discusses alternative assets, shifting currents within the industry, and how management fees are like a two-by-four.

**Aly Jeddy and
Gary Pinkus**

Jim Coulter is cofounder and CEO of TPG, a leading global private-investment firm. As one of the principals in the creation of the modern private-equity industry and an experienced investor in alternatives, Coulter has seen most of the sector's ups and downs. McKinsey's Aly Jeddy and Gary Pinkus spoke with him in September 2014. The following is the first part of the conversation; the second part will be published in the next edition of *McKinsey on Investing*.

McKinsey on Investing: *Looking ahead at the next five to ten years, how do you think the alternative-asset-management industry will evolve? What wild cards might be out there?*

Jim Coulter: I think people may continue to be surprised by both the industry's rate of growth and its increasing complexity. In 1992, when TPG started, a forecaster would have massively underestimated the growth and the increase in scope of the industry. We risk making the same mistake today. We now have pretty compelling data that, whether on returns or Sharpe

ratio, the asset class on balance has performed at levels that make it likely to continue to attract capital. An important consideration here is the ongoing general debate about passive versus active management. Active management has become the flavor of choice for certain investors—perhaps the only practical flavor for them—and they've been paid handsomely for participating, including risk and liquidity premiums. Our investors are voting with their dollars: they're holding or increasing their commitment to alternatives.

McKinsey on Investing: *Are you also seeing new investors enter the business?*

Jim Coulter: We've seen new entrants of almost all sorts. At one end, private equity and alternatives have become an acceptable asset class for the largest owners of capital in the world, sovereign-wealth funds, and other government-related funds. Outside of Singapore, this was probably not true 10 to 15 years ago. At the other end, alternatives have certainly captured the attention of high-net-worth and even retail

investors. While to date these groups make up only a small part of the market, if those paths open up and returns continue at today's level, they may be a substantial contributor to industry growth.

McKinsey on Investing: *Private equity—and buyouts in particular—is a big part of alternatives. Is there a natural limit to the growth of buyouts? Will the secular-growth trend run out at some point?*

Jim Coulter: Today it's unclear, at least in the United States and Europe, whether the secular-growth trend in buyouts may be flagging. Let me make both sides of the argument. First of all, growth in private-equity assets under management has begun to flatten. That's visible in the distribution-to-capital-call ratio, which has moved to close to two. The industry is returning substantially more capital than it is calling. Further, the volume of new transactions in private equity as a percent of assets under management has decreased. If you disregard secondary buyout transactions and look at new purchases of assets not previously held by private equity, they are at a historic low. So that would argue that the meteoric growth of the past 20 years has potentially begun to level off.

On the other hand, the real-estate market, where substantially more assets are held in private hands than public hands, might be a model for private equity. Among companies, there has been a long-term secular movement toward public ownership. As private equity has grown, many have wondered whether private ownership might not be a better model. So there's a possibility that we will see an increased mix of private versus public ownership of large corporations.

The other thing that argues against the plateau is that any time in the history of this business we probably could have argued that growth would level off. Instead, growth in assets under management has continued in a way that has surprised even those of us close to the market.

McKinsey on Investing: *Your firm and many of your peers have increasingly adopted a multiasset strategy. What are the arguments for and against that approach?*

Jim Coulter: The shift to multiasset is often portrayed as general partners (GPs) leading their investors. We tend to view it as limited partners (LPs) leading the market and GPs serving their clients. Alternatives began in equities; you can think of private equity as bringing alternative asset tools to the equity marketplace. Over the past few years, the application of alternative asset tools to the credit markets has probably been the fastest-growing segment of the industry. Additionally, we've seen growth in hedge funds, which are active managers in a variety of different public markets. We're on a long-term trend: the wave of active, alternative management that started in private equity is now heading into hedge funds, debt, real estate, and other related asset classes, driven by LPs looking for differentiated returns.

In this evolving marketplace, LPs tend toward a "barbell" strategy of investment. On one side of the barbell, there are point products, such as small, midmarket buyout funds or Asian country funds. Many LPs seek these products, but they are difficult to scale, and as these areas are often new, LPs are faced with new managers. On the other end, there are firms that offer multiasset solutions, such that a state pension-fund client can invest

in multiple products with the same manager. Both of these approaches are creating acceptable and interesting returns.

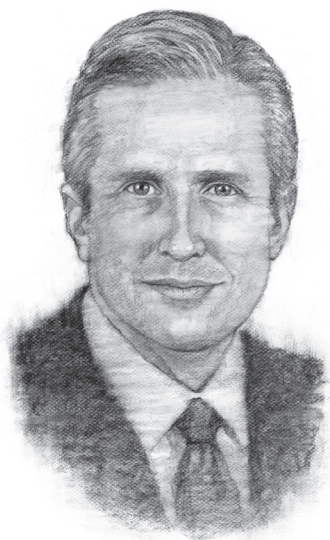
McKinsey on Investing: *You could argue that solutions firms are providing a single point of entry to multiple products with a common brand. But you could also imagine much more customized solutions across those products, designed to answer particular problems.*

Jim Coulter: Sure. I find this structural tension—point products versus solutions—occurs in lots of intellectual-property industries. A company could buy specialized consulting products from a number of small consulting firms, or it could purchase a bundle of them from a larger

firm. For its investment-banking needs, a corporation could work with a small boutique, or it could work with one of the large banks on a broad-based set of solutions. Likewise, in the regular asset-management business, investors tend to cluster around the large platforms, such as BlackRock or Fidelity, that can offer multiple and tailored solutions to their needs. So the solutions-based industry structure we see developing in alternative assets should not be a surprise; the recent acceleration in this trend is, however, a surprise.

McKinsey on Investing: *That goes back to the original point you made, about the rate of growth and rising complexity.*

Jim Coulter



Vital statistics

Born December 1, 1959,
in Buffalo, NY

Married, with 3 children

Education

Graduated from
Dartmouth College and
Stanford Graduate School
of Business

Career highlights

TPG (1992–present)

Founding partner and CEO

Keystone Asset Management (1986–92)

Fast facts

Serves on numerous
corporate and charitable
boards

Serves on the Dartmouth
College board of trustees
and the Stanford University
board of trustees

Cochairs the LEAD
Commission, which seeks
to develop a blueprint
detailing the opportunity
for using technology
as a catalyst to transform
and improve American
education

Jim Coulter: And diversity. Many people still think of Blackstone as a private-equity fund, but if you look at its asset mix, it's only about 25 percent private equity. It's been a stunning change since 2005. The same is now true of other large firms. That expansion of products and rapid growth away from private equity is indicative of some of the trends within the industry but also of the buying trends of the LPs.

McKinsey on Investing: *You could imagine a world emerging like the one often speculated about years ago, in which hedge funds and private-equity firms seemed to have overlapping mandates, at least for a period of time. Do you think traditional asset managers with an alternative capability are starting to merge with alternative asset managers that may or may not have a traditional capability?*

Jim Coulter: It's going to be interesting to watch this play out. Your research tells us that in the next decade or so, perhaps 40 percent of the entire fee base of the asset management business will be in alternatives. Leading traditional managers will find it hard to ignore the need to either build or buy an alternative asset business. At the moment, we do not see traditional asset managers as competitors at the front lines of our business. We haven't been bidding against them for assets, other than in certain growth areas where they will invest directly as bridge capital in front of an IPO. But generally, they're not active as primary producers. Where they are active, and where they'll claim fairly large assets under management, is as solutions providers to their investors through funds of funds, bundling of hedge-fund products, and occasionally secondary participation in alternative assets. So it's not inconceivable to me

that over time traditional managers will consider purchases of alternative asset platforms as a form of forward integration into investing areas they haven't been able to build internally.

McKinsey on Investing: *What about the flip side of the question: Is there anything interesting in traditional managers for alternative firms?*

Jim Coulter: Yes, it might make sense for one of the leading alternative asset platforms to buy a traditional asset manager. Some of the cultural aspects may be difficult, however. The argument for such a purchase would be based on improving customer relationships, distribution, and scale.

McKinsey on Investing: *All of this is based on the higher fees that alternatives currently command. Where do you see those fees going? If more capital comes in, will the price that you can charge for that capital continue to come down? Or do you see some break in that trend?*

Jim Coulter: When we talk to people about alternative fees, I always hear about 2 and 20. My response is to ask them, how large is a two-by-four? The answer is that it's about an inch and a half by three and a half. A two-by-four is not a two-by-four. Likewise, 2 and 20 doesn't exist in the large-scale private-equity market, other than for some small products. There has already been a substantial move in fee structures. It doesn't always show up in the headline pricing, but it shows up in discounts for size and for first closers, as well as in changes in transaction-fee splits between LPs and GPs and in coinvestment, the topic of the day. Fees per dollar invested have generally been decreasing for larger firms, and I expect that to continue.

Alternative asset managers have two choices. You can maintain your fund size, in which case you may be able to maintain pricing. Or you can grow your fund size, either from new investors or more capital from current investors. As you grow, you will see, as you do in most industries, a reduction in pricing. I don't think that's a bad thing. I think it's true in almost all financial products over time. As they grow and mature, pricing tends to come down.

McKinsey on Investing: *You talked about coinvestment. Some LPs are building true direct-investment programs, doing what I'll call parallel play to what you are doing. Do you see that as a blip or more of an enduring trend?*

Jim Coulter: Relationships between LPs—especially the larger investors—and GPs will get substantially more complex. Ten years ago, the market was clearly dominated by fund vehicles in an LP or GP setting, and essentially all LPs paid the same price, no matter their size or influence. When you think about it, it's an odd structure. There are very few industries where people who invest \$10 billion pay the same fee as people who invest \$10 million, but that was where alternatives were ten years ago. A number of the large LPs began to ask whether they shouldn't get better terms, given their size. Others began to see if they could go around GPs, which they viewed as expensive, to approach the market directly.

This trend has played out in a couple of ways. First, several larger LPs began coinvestment programs, which they viewed as a way of meeting excess demand and reducing the overall cost of their program. In some ways, coinvestment began to squeeze out GPs' traditional process of partnering

with one another when they needed more capital. Coinvestment essentially pushed out consortiums, which the GPs welcomed.

Second, some of the larger LPs realized that they were investing enough to warrant an internal staff to make judicious decisions on direct investments. Generally, they chose to make those investments in partnership with their GPs. However, coinvestment structures allowed them to reduce costs while increasing the size of and influence they had over certain investments.

What we have not seen yet is extensive direct disintermediation; there have been few direct deals not done in partnership with one of the GPs. However, it may well happen in the future.

McKinsey on Investing: *And your view is that this just adds complexity to the market, rather than shifting the power dynamics?*

Jim Coulter: This market will inevitably become more complex, just as most financial markets do over time. Large investors will require some choice of structures and deserve a response. It's a little bit like the airline industry. The largest carriers can sit down with manufacturers to design the next generation of aircraft. Small carriers just buy an airplane. Likewise, large investors will continue to help design the structure of the alternative asset industry, and GPs will be responsive to their desires.

Interestingly, one of the risks to larger investors will be if the retail markets open up, allowing individual investors to enter the alternative market. This could reduce some of the market power of the large institutions.

McKinsey on Investing: *Recently, the California Public Employees' Retirement System said it will get out of its investments in hedge funds. Obviously, this is interesting in and of itself—but is it a bellwether of a larger trend?*

Jim Coulter: In a bull-market period when multiples are expanding, generally speaking, passive management will look relatively more attractive than active management in the public markets. The past few years have been one of the stronger periods of multiple expansion, certainly in my career. One could argue that, during this period, investors in hedge funds have

not seen adequate returns for the fees involved. It's not true of all hedge funds—many of them work well. But will the outperformance of passive management be true in the next part of the cycle? Only after the cycle turns should we comment on whether the decision to exit hedge funds is right or wrong. In the short term, though, we do think we will see pressure on hedge-fund fees. ◉