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A conversation with Jim Coulter

In the second part of our 2014 interview, the veteran investor talks about emerging markets, industry consolidation, and why private equity is as bold as it ever was.

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 other 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 first part of the conversation can be found on mckinsey.com.

McKinsey on Investing: *Market multiples, at least in the Russell 2000, are at historically high levels. What are the implications for private-equity returns?*

Jim Coulter: Given the current low-interest-rate environment, multiples for midsize companies are at levels that make me very nervous. Over the past four or five years, increasing multiples and

rising earnings have floated almost all boats in public and private markets. However, today when we run three- to five-year models, we are consistently underwriting to exit multiples below today's levels. To reach the returns we seek for our investors in a period when we might expect multiples to contract, we have to find situations where growth or a positive discontinuity in the company's performance will create excellent returns. It is a period where private equity's ability to add value will drive performance that won't be available in the broad public markets.

McKinsey on Investing: *So there are certain subsectors where you'd expect multiples not to deteriorate or perhaps even to increase?*

Jim Coulter: Even if multiples come down, the growth and disruption in certain subsectors of the economy is such that you can reach returns

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

that we consider attractive. For example, there is a fundamental shift under way in the healthcare industry, which represents an enormous portion of our economy. Government efforts to reshape the industry can provide significant opportunity if you know your way through the industry chaos. The combination of shale technology and price instability in the energy markets is currently yielding a very interesting set of energy-sector opportunities. E-commerce is disrupting the retail industry at an increasing rate. We are in a period when there will be a premium reward for wise sector choices.

McKinsey on Investing: *When you invest in these sectors, presumably you make different assumptions than you might in a classic leveraged buyout. How does the analytic process change, if at all?*

Jim Coulter: We've been very careful through this cycle not to lean too heavily on leveraged returns. In some ways, leverage can be the devil's candy of

private equity. In 2007, 59 percent of leveraged buyouts were done with leverage ratios greater than six times. From 2009 to 2011, that fell to 13 percent. But in the second quarter of 2014, 72 percent of deals were done with more than six times leverage. One of the misconceptions about private equity is that periods when leverage is easily available are good for the industry. In fact, such periods tend to drive higher pricing, and my experience has been that one of the things you can't fix in the private-equity market is price. So in this cycle, we have not been leaning into the full availability of leverage in the marketplace.

At TPG we think of private equity as three types of business. One is traditional buyouts, typically high-quality companies where balance-sheet change and investment insights are the key differentiators. The second is transformations, which usually involve a change in management and almost always a strategic change. The third is more off

the beaten path: one-off, situation-specific restructurings of one kind or another.

Today we are doing fewer traditional buyouts than we have at other times. The reason is not that there aren't some great companies for sale but rather that the combination of high multiples and widely available leverage suggests to us that this is a time to pull back from these types of transactions. On the other hand, the amount of disruption in the economy in various sectors means that we are doing more of the second type of investing, transformations. We are focusing on buying companies and changing them, which can pay off in interesting ways.

McKinsey on Investing: *Will that change as the economic cycle changes?*

Jim Coulter: In the early part of the cyclical upturn, one wants to invest in companies that will respond well to broad-based expansion. Consensus would put us now somewhere around the midpoint of the cycle, particularly in the United States. At this stage, I counsel caution on making cyclical calls, and a focus on sectorial or secular calls where one chooses industries or specific situations that are interesting. It's the equivalent of a stock picker's market. Later in the cycle, one might move into a more defensive posture.

McKinsey on Investing: *At the risk of asking you to call something that's uncallable, do you see a couple years remaining in this cycle?*

Jim Coulter: We're pretty constructive on both earnings and the market in the intermediate term. Our companies are doing well, with earnings before interest, taxes, depreciation, and amortization across the portfolio up 13 percent in 2013, and momentum seems to be continuing. However, for new investments, we are looking not at the intermediate term but out three to five years. As

we get closer to the top of the cycle, we tend to become more conservative on the economy in general and more micro focused. It is a time to rely on our differentiated sector expertise to see things that the market doesn't. That's what active management and creating alpha is all about. So while we are constructive on the near term, we are increasingly cautious as we consider new investments. It's an interesting dynamic.

McKinsey on Investing: *Where are you seeing the greatest growth in the alternative-asset marketplace?*

Jim Coulter: Over the past few years, the greatest growth in alternative assets has actually been in credit-related products. That's been driven first by investors, who have exercised caution in the aftermath of the financial crisis; the coupon and downside protection have seemed relatively attractive. Second, it's been driven by performance. The historically low interest rates have obviously driven any credit-related product to reasonably strong performance over the past five to seven years. And third, many investors have had a desire for more alternatives, but with already relatively full allocations to private equity, they have been branching into credit.

Alongside credit, there's an area that I'm not sure I can quite define called "opportunistic," which a surprising number of our investors are designating as an asset class in its own right. These investments can sometimes be credit, sometimes equity. They're often highly structured. They can be distressed debt, medical royalties, intellectual-property portfolios, agricultural land, or timber. These assets may not have shown up historically in investors' portfolios but are areas of increasing interest to institutional investors.

McKinsey on Investing: *What has been happening in private equity outside the United States?*

Jim Coulter: The most attractive region for private equity over the past five years has been the US, not emerging markets, which have underperformed. That's due in part to the stock markets in those areas and in part to disappointing growth relative to expectations. European credit has been an area of high interest to limited partners [LPs] and provided good early returns. There's an emerging desire for what are sometimes called frontier markets: Africa, non-China and non-India Asia, Brazil, Colombia, Mexico, and Turkey.

McKinsey on Investing: *The approach to investing in emerging markets is different. How would you characterize it?*

Jim Coulter: It's a different business. Quite often if companies in these markets want to sell control, you don't want it. Investing in these regions is more about growth and partnership than leverage. And it's about value-added investing. If you think you're going to go into Asia because they need the money, you haven't studied economics recently.

McKinsey on Investing: *Partnership in these investments often comes down to control. We see control investments on the rise. Your thoughts?*

Jim Coulter: I would say they are on the rise, particularly in China and India. But they are still a relatively small part of the market. And emerging-market private-equity firms often define control differently. You'll find that most Asian general partners [GPs], if they have the right to a board seat or to appoint the CFO, they count that as control. But it's a shared control rather than absolute control. In many ways, it resembles the growth equity market in the US more than it does the traditional private-equity market.

McKinsey on Investing: *What do these regional differences mean for industry structure? The industry continues to have a lot of firms, but capital*

has concentrated dramatically in just a few of them. Do you see that changing?

Jim Coulter: The industry will likely always be a complex combination of point products, specialty firms, and a limited number of large platforms. However, at the moment, it is relatively unconsolidated compared with most other financial-services industries. The entrepreneurial nature of the business means that it will not become as consolidated as many other financial services.

But we do think consolidation will increase, in part because the increasingly sophisticated large platforms are likely to grow faster than the rest of the industry, as they have been doing for the past seven or eight years. Second, a generation of firms has grown up and in some ways institutionalized over the past several years. Their founders are nearer to the end of their careers than the beginning. How leadership passes to the next generation, or whether some of these firms will consolidate, will be one of the more interesting dynamics to watch over the coming years.

McKinsey on Investing: *Mergers of firms in talent-based industries are often quite difficult. If they begin to happen, what do you think will drive them?*

Jim Coulter: One factor is capital. A key question for larger platforms as they mature is how important capital will be in that maturation. A number of the large platforms have been quite intelligent about using capital to build products and serve their clients.

A second factor is that with some participants now publicly traded, we see that there is enterprise value within private-equity firms. Founders and partners will want to realize the enterprise value they have created. The highest enterprise value is likely to be for diversified platforms. Investors will always be worried about single-product financial firms, whether they are investment banks or asset

managers. If partners in firms require liquidity or access to value, a larger diversified platform may have advantages relative to individual-firm solutions. This could drive consolidation.

McKinsey on Investing: *If firms can solve that problem, how do they then manage the resulting combined firm? What are your thoughts on talent management in professional-services firms? Has it changed?*

Jim Coulter: At the end of the day, we have two raw materials: people and capital. Of those, people are the most likely source of long-term advantage. We consider ourselves a deeply talent-driven organization. My job as CEO is to enable and empower the “special forces”—our professionals, whose job is to go find next year’s ideas and new areas with the right risk-reward ratio to take to our clients—and to continue to grow and innovate at our firm. Private equity continues to be a destination of choice for people who are interested in both investing and having an impact on the company they work for.

I tell people entering our organization today that it’s the most fascinating time ever to be at TPG because your potential career path and intellectual growth have more upside than they ever have. If you want to build a traditional career in private equity and grow to run a sector, you can do that, but you can also transfer to our Beijing office, move over to credit or to hedge funds, or work in our distribution group. We now have more diversity of choice for

people who want to be entrepreneurial with their careers than we have ever had.

McKinsey on Investing: *Some say the industry is now less bold than it once was. What are your thoughts?*

Jim Coulter: I think that’s a misconception. The analogy I might use is that when you’ve been at a rock concert for four hours, it doesn’t seem so loud anymore. If you’ve been watching private equity for 25 years, the boldness continues, although we are perhaps more inured to it. TPG began its existence with an airline restructuring, one of the biggest bankruptcies in that era. At the time, one of our LPs told us, “If it wasn’t you, I’d think this was crazy.” And yet today, there are whole firms built on this concept of restructuring bankrupt companies. Similarly, when we went into South Korea in the 1990s to restructure a bank, people scratched their heads. Well, we just restructured a bank in a much more exotic place, Sri Lanka, and barely anyone noticed.

Private equity is constantly moving out to the edge of new things, but because the industry is so big and complex, these moves don’t stand out as much as they did historically.

McKinsey on Investing: *A final question. Secondary buyouts are about a third of the buyout market in the United States and more than 50 percent in Europe. LPs now have a decent chance of*

“We have two raw materials: people and capital. Of those, people are the most likely source of long-term advantage.”

being on both sides of these transactions. They owned the company before, and they owned it afterward, through two different GPs. Can you imagine a model emerging of some kind of permanent capital, which would remove transaction costs for LPs and allow them to manage to their liability stream in a way that's more efficient for the market overall?

Jim Coulter: I would make two points. First of all, secondary buyouts have performed much better than people had expected. They have tended to be less volatile and to perform in line with primary buyouts, in part because seasoned companies with demonstrated ability to function with leveraged balance sheets tend to dominate the secondary-buyout market. Second, a number of LPs and GPs are examining the question of whether there are alternative structures and different economic arrangements that would allow them to own assets for much longer periods of time. I think this is probably a likely evolution, but an evolution that will be challenged by the difficulty of knowing a priori which companies deserve a longer hold.

McKinsey on Investing: *So rather than a fund of permanent capital, you see potential for a structured set of investments in which some would have a component of longer-term capital?*

Jim Coulter: Yes. If you think about it, we have a limited-duration fund, and we're measured by how much capital we return over that time, which is when we're fund-raising again. That creates some incentives—not huge ones, but still incentives—for us to sell assets while our LPs are still comfortable holding them. So the question is whether there are ways to extend the holding period for certain companies in a way that would be attractive to both the LPs and GPs. I'm not sure that structure has yet been created successfully, but I suspect there are discussions under way. ■

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