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WARBURG WON'T ARGUE WITH HALF CENTURY OF SUCCESS

HISTORIC FIRM DEFIES CONVENTIONS AND REMAINS A POWER IN THE COMPETITIVE PE UNIVERSE

BY BOB O'BRIEN

The DNA of the private equity business has changed rather drastically in the past several years, a transformation that's reflected in the vernacular—or, more specifically, the acronyms—of the industry. PE used to be the LBO business, a model captured (some would, accurately, say stigmatized) by the pop culture phrase "OPM."

But as private equity has evolved, it has diversified away from its origins as a financial mechanism for buying businesses and flipping them for a profit. Now, credit funds, real estate purchases and secondary investing—not to mention hedging strategies, mezzanine financing and commodity trading—have become common avenues for investments by PE firms.

Not so for Warburg Pincus. One of the oldest of the private equity enterprises, dating to 1966, **Warburg Pincus LLC**, as the firm is formally known, is pretty much what it was half a century ago: a business of buying, or starting, companies; managing them into maturity; and selling them, hopefully at a profit. Its fact sheet credits the firm as having been "instrumental in creating the private equity industry."

"From Day 1, we've viewed ourselves as an investor," Joseph Landy, co-CEO, said in a recent interview in the firm's office on New York City's Lexington Avenue.

Which isn't to say the firm is fashioned along the leveraged buyour model portrayed in the movie "Wall Street."

"Among the defining characteristics of the firm is that we've always been a growth-oriented investor, rather than focusing on a leverage centric deal business," Charles Kaye, known better as "Chip," the firm's other co-CEO, said during the interview with both executives. "We're creating our own deal flow rather than waiting for opportunities to come to us."

CO-CEO JOSEPH LANDY

CO-CEO CHARLES KAYE

A number of characteristics distinguish Warburg Pincus from its contemporaries. Not that either executive has anything disparaging to say about their contemporaries in the PE community. "We're very proud of our industry," Landy said.

For one thing, the firm eschews the convention of fee collection that comprises one of the most reliable sources of revenue for most PE firms.

"We don't take deal fees, we don't charge monitoring fees," Landy said. "We generate our carry, which is where we receive our returns. We feel as if the entrepreneur that we've partnered with has done well, if our investors have done well, then we will have done well. Our interests are aligned with the management teams we partner with and the investors who support us.

"We see the roots of our industry—and the roots of our firm—as being aligned with the interests of the entrepreneurs with whom we partner and the investors who support us," he added.

It can make for a somewhat lumpy financial performance.

The firm's Warburg Pincus Private Equity X LP, which began investing in October 2007 after raising $15 billion, generated a net internal rate of sub-par return by Warburg standards of 9%. However, its successor fund, which raised $11.2 billion, and began investing in May 2012, produced a net IRR of over 20%. The IRR figures are according to the performance summary of the Washington State Investment Board, an investor in the firm, and are as of last June. Its last four funds that the Washington state board reported on, dating to 2005, have generated an average net IRR of 14%, according to that data.

In addition, Warburg completed fundraising for a $12 billion global equity investing fund in November, exceeding its target in a relatively truncated six-month capital-raising process.

Another distinguishing factor: The firm has avoided the impulse to go public that gripped the PE world beginning in 2007.

Asked point-blank if Warburg Pincus would pursue an initial public offering in the future, both co-CEOs answered determinedly "no," and then paused—as if there was no reason to amplify their response.

The conventional wisdom in the PE realm is that the push to enter the public markets was to create an avenue for firm founders, some of whom have aged with the industry, to monetize their fortunes upon retirement without disrupting the balance sheets of the enterprises they created and nurtured.

The extent to which this is true is open to debate. Public markets also provide younger, ambitious partners, who may be chafing at the determination of the industry's Old Guard to remain in place, to capitalize their own investments in the firm and, in many cases, strike out on their own.

Warburg Pincus doesn't have the same clock ticking, as it were. Kaye is 51; Landy is 54. Both of their careers would seem to have a few years remaining, and both demonstrate an enthusiasm for the business that suggest they aren't moving to Taos to throw pots anytime soon.

Kaye said he believed that PE firms that pursued public monetization did so to diversify away from the conventional LBO model that the PE industry fed on for so many years. "I believe that a number of firms went public because they found the pure LBO model to be waning," he said. (Goldman Sachs famously declared LBOs to be dead last year, an assertion that, while open to debate, does give some insight into the changing zeigeist of the PE business.) "I think going public allowed some firms to diversify into other investment classes and pursue additional deal streams."

So, are LBOs, in fact, dead? "Everything goes in cycles," Kaye said. That's part of the reason why Warburg Pincus pursues a diversified investment approach, investing across a broad swatch of industries and geographies. The firm, for instance, has made seven investments in India in the past year.

"Over the course of roughly 30 years, entrepreneurs in those regions know that they have a partner that's there to stay," Landy said. "One third of our professionals are based outside the United States. We're one integrated global firm that has the capabilities to succeed overseas.

"If you look at the headlines that have discussed emerging markets like China, they've focused on the export market," he added. "But we're not focused on investing in steel exports. Our focus has been on the consumer areas of the economy, which is where you can do quite well—whether it's banks or healthcare, there's a vibrant domestic economy in China and that's where we've focused our energy."

"We're a globally integrated investment firm," Kaye said. "It's really a traditional partnership, if you will. And it's a very powerful model."

Unlike firms that launch multiple funds with specific disciplines—some PE firms have more than 100 funds, committed to distinct industries, such as technology, energy or consumer products, for example, or, in other cases, specific geographies or deal sizes—Warburg has a single global investment fund. Its sole fund has the latitude to invest across categories.

"Our diversified approach has fueled the persistence of our returns," Landy said.

Nor is the firm constrained by size. "We're willing to start small," Kaye said, adding that smaller deals presume there will be growth opportunities down the road. "You can start with an investment that begins with $15 million or $20 million, and as long as you add to it, it starts to become tens of millions of dollars, and then it can grow into hundreds of millions of dollars." Another benefit of investing in start-ups and smaller enterprises: businesses with those characteristics don't have the kind of balance sheets that support overwhelming leverage, leaving Warburg less exposed to the vagaries of the credit markets—something that proved beneficial in the third quarter of last year when debt markets suffered some hiccups.

Not that Warburg hasn't stubbed its toe on occasion.

The firm invested in the mortgage insurer **MBIA Inc.** when its credit rating was imperiled during the financial crisis. The firm then pumped in more capital when the company subsequently undertook an IPO.

On the other hand, it showed its operational legerdemain in October 2007 with its $4.5 billion purchase, which included $1.7 billion in an equity investment, in **Bausch & Lomb**, the eye-care products maker that was recovering from troubles with a cleaning product that caused eye infections. Under Warburg's stewardship, the company recovered, and the PE firm reportedly tripled its investment in a subsequent sale of the company to **Valeant Pharmaceuticals International Inc.** (VRX).

Looking ahead, both Kaye and Landy see a PE market that performs much as it has functioned over the past two years, as the recovery from the financial crisis has been completed, and macro events—low inflation, access to capital and a robust fund-raising environment— remain staples of the business, even in an era when interest rates appear to finally be ticking higher. The firm thinks it will continue to maintain its rather robust role in the business. "In our five decades of operation, we've never had a return that was below the median of the industry," Landy stated.

Of course, there are persistent geopolitical risks, and the unforeseeable exogenous event can't be ruled out. With so much capital floating around, and new entrants such as sovereign wealth funds competing for deal flow, pricing pressures should persist.

"Pricing is highly competitive. Interest rates are low, capital is readily available. We live in a market of abundant capital," Kaye said. "That creates challenges."

But Warburg Pincus believes it's better insulated than some of its industry brethren. With its years of experience and depth of talent, it's honed its approach to deal sourcing in ways that keep it from competitive situations where bidding can compromise those returns.

"Of the investments in our last portfolio, more than two-thirds of those were deals sourced in house," Landy said.

The firm is proud that it's built a model that can survive, and even thrive, under any economic circumstances.

"Even in the darkest days of the financial crisis, we were able to take companies public," Landy said. "We feel that if you build a real business, there's always going to be capital available to support it." ■

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