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Terra Firma rethought

As Terra Firma prepares to return to market, Guy Hands, the firm's founder and chairman, explains why the changing GP-LP dynamic requires more flexibility on structures and fees, and GPs with more skin in the game

Q: What is your view of the global PE investment environment?

A: There are two big issues. First, you've got more money coming into private equity and you have more LPs looking to invest directly or do co-investments. Put these together and there's about $2 trillion in dry powder globally. Second, the number of deals completed by the private equity community is the lowest in about 13 years. Although M&A activity is increasing, the percentage of transactions involving private equity buyers is decreasing. This is because strategic investors have come to the market. Due to the strong stock markets worldwide, they have a lower cost of capital and they benefit from the synergies generated by their transactions. This effect is huge in a low interest rate environment.

Q: LPs are looking to access the asset class through structures that are not blind pool funds. How can you respond?

A: GPs are sitting on a lot of dry powder and substantial fees are being paid on it, so LPs are getting upset. Some are saying that this is a reason for them to do less PE. We have responded in two ways. First, we recognize that it is very difficult for fund managers to deploy capital in the current environment and so we want to have a smaller amount of money to invest. Last time we raised a EUR5 billion ($5.5 billion) fund; we think it would be difficult to invest a fund of this size in the right opportunities at present. Second, we will not charge fees on un-invested capital. This means there will be no pressure from investors, asking 'When are you going to invest?' We can take our time and deploy capital in an opportunistic way.

Q: Will other GPs follow suit?

A: I don't think they will follow us. There are two reasons for this. First of all, the big firms have hundreds and in some cases thousands of employees, and they need to feed the machine. If they are publicly-traded they also need to feed their shareholders. They can't afford not to operate under a fee-driven business model. Smaller private equity firms can't afford to do it either – they need those fees to keep the business going. We're sort of in between. In this position there is always a risk that you'll be squeezed, but there is also an opportunity to do something different. We think we are big enough to support ourselves, but small enough that we are not reliant on public shareholders.

Q: Large LPs are also writing bigger checks. What does this mean for GPs "in between?"

A: The big LPs get into very good deals at much lower fees with the larger funds, so they tend to focus on the big brand names. They tell us that in order to compete with larger funds we need to do something different. Therefore we have a different approach to fees and we are focusing on different types of investments. We want to provide to them with alpha, whereas bigger funds provide beta at reasonably low cost and they are quite efficient and effective.

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Q: Terra Firma plans to commit at least 10% to each deal or to the fund, much higher than most GPs. Why is it important to have skin in the game?

A: Four of our five funds have done very well and we have about EUR1 billion to invest. Two strategic investors previously came to us with opportunities and said, 'This is the deal we want to do but we don't have the expertise in Europe. We want someone to invest and manage the asset.' We agreed to become involved and put in 10%. In one of these cases, there was a difference of opinion on price; we didn't think they should pay as much as they were willing to pay. We had a view about where we wanted to put our 10% and so in the end we didn't do the deal. This was a good result because we thought it was the wrong price to do the deal. We are putting 10% of our own capital into any transaction, which means we will act with a lot of discipline.

Q: You have greater flexibility in fund structure. Will there be more flexibility in strategy?

A: We look at infrastructure, residential real estate and private equity – the same areas we've been looking at for the last 20 years. It's quite opportunistic. At the moment we think the residential real estate sector in Europe offers good value. It is difficult to say anything is cheap in this market, but we can say value is better in parts of Europe. In PE, there is some distress in some businesses because they are over-levered or need operational change and this provides opportunities. On the other hand, core infrastructure is very expensive at the moment in Europe.

Q: What do Asian LPs want from Europe?

A: I would say that there is an interest in companies that have an affinity with Asia – businesses that are present in the region and people feel will bring some technological advantage. Healthcare is a good example. We have a large elderly healthcare business in the UK and there is a lot of interest from Asian investors. In Japan, we see a lot of interest in how to do business transformations. We have always been very active in terms of changing management teams or changing the ways in which our portfolio companies operate. In China, there is more focus on businesses that might bring strategic value to China. In Hong Kong and Taiwan they are more interested in European real estate.