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THE WALL STREET JOURNAL

FRIDAY - SATURDAY, JUNE 1 - 2, 2001 23

VENTURE CAPITALIST

BY CHARLES FLEMING

S&P Rating Opens Private Equity Fund To Bond Investors

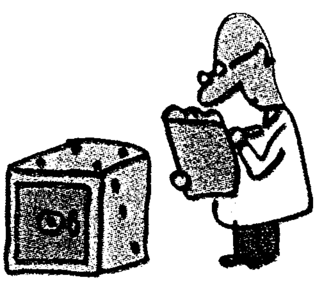
PARIS

The pool of money available to buyout and venture capital funds on both sides of the Atlantic suddenly got a whole lot deeper.

For the first time ever, a private equity firm has obtained a Standard & Poor's credit rating on a new investment fund. That may sound like an arcane detail, but it is significant to money managers because it will allow bond investors to put money into buyout and venture capital funds.

"This is the first transaction of its kind to get a public rating and it opens the way to a whole new arena of investors," said Soody Nelson, the head of Standard & Poor Ratings Group's structured finance market value unit in New York. "It's taken us about nine months to get comfortable with the asset class," she said. Ms. Nelson expects to see several similarly structured investment vehicles receive credit ratings and hit the market in the course of the year.

As things stand today, when private equity funds raise money they have to pitch for the small percentage of a pension fund's or insurance company's assets earmarked for "alternative investments." "Alternative" means anything that isn't stocks and bonds, and usually includes private equity, hedge funds, and real estate. The problem, however, is that most institutional investors don't allocate much more than 5% to alternative investments because they are concerned about the risks inherent in locking themselves into illiquid asset classes.



A credit rating on a private equity fund opens up a new comfort zone for those investors. The way that the Swiss private equity firm Capital Dynamics has structured its new €150 million Prime Edge Capital fund has effectively turned a big chunk of it into a plain vanilla bond issue, which can then be traded. "It's the bond element that's never been done before in a private equity fund," says Thomas Kubr, partner of Capital Dynamics.

Working with Deutsche Bank, the firm has raised one-third of the money in the form of straightforward equity notes, not much different from the way investors usually put money into private equity today. The other two thirds, however, takes the form of senior debt notes with a maturity of 12 years and a variable quarterly coupon, currently at about 7.5% a year. The senior notes are the part that has been rated by Ms. Nelson's S&P team, receiving a double-A grade. Over the next five years, Capital Dynamics will invest all the money raised in a number of European buyout and venture capital funds, acting effectively as a fund that invests in other private equity funds.

European private equity managers clearly are happy about that. "This opens up a deeper pool of money. It's a leading-edge product and others will follow," says Bruce Barclay, a director at private equity firm Advent International in London.

Prime Edge isn't the first time that a private equity firm has tried to reach risk-averse fixed-income investors. Most notably, Partners Group in Switzerland (Mr. Kubr's previous employer) raised $700 million (€817 million) through a convertible bond issue in 1999, and then invested the money in private equity funds. That issue was covered by a Swiss Re insurance policy, earning it an S&P investment-grade rating. But in that case, the rating covered the insurance policy rather than the underlying private equity assets. Prime Edge also has an insurance policy on its senior notes but Ms. Nelson said the latest S&P rating covers the underlying assets. "Even without the insurance policy, the (Prime Edge) deal would have received single-A and triple-B ratings," she said.

The implications of the Prime Edge rating are enough to cause other bankers to sit up and take notice. "It's definitely a breakthrough," says Dansby White, head of structured finance at Merrill Lynch in New York. "What's different about Prime Edge is that it shows credit agencies are getting comfortable with securitization of pure private equity and that allows us to bring more traditional fixed-income investors into the field," he said.

Even S&P's rival, Moody's Investors Service, says it's likely to follow suit. Prime Edge's rating "is less of a breakthrough and more of a continuum in broadening the types of asset classes that can be securitized," said Daniel Curry, managing director of the Moody's international structured finance group in London. "We have people looking at determining values for a wide range of assets, including private equity. I expect that we'll rate similar transactions in the future," he added.

One important question that remains is whether the private equity market actually needs access to the much deeper pool of money represented by the fixed-income investors. Already, some private equity investors are anxious that buyout and venture capital firms have already overstretched themselves by raising a rash of billion-dollar funds in the last year at a time when returns are dropping. "A year ago, people would do anything to get into private equity, but now they are reassessing how much they want," said Mr. White at Merrill Lynch.

But others argue that private equity investment opportunities are far from saturated. "The uses of private equity as a source of corporate finance are growing," said Mario Giannini, president of private equity adviser Hamilton Lane, in Philadelphia, which is helping Capital Dynamics with Prime Edge's investment strategy.

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