Testimony on Legislation to Provide a Registration Exemption for Private Equity Fund Advisers

By

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Subcommittee on Capital Markets and Government-Sponsored Enterprises
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Chairman Garrett, Ranking Member Waters, Members of the Subcommittee: Thank you for the opportunity to testify today on this important legislation.

My name is Pam Hendrickson, and I'm the chief operating officer of The Riverside Company. Riverside is a private equity firm that manages $3.5 billion of investor funds. We use that money to buy and build small companies – companies with annual operating cash flow under $20 million that, with Riverside's capital and guidance, will grow and create hundreds of jobs. Many of those jobs are in small towns across America where the Riverside-owned company is a major employer. Today, Riverside owns 50 companies in the U.S. Together, those companies employ more than 10,000 people. We're not alone. There are more than 2,000 other private equity firms like us that buy and build small and medium-sized companies in the U.S.

I'm here to support legislation introduced by Representative Hurt of Virginia that would eliminate the requirement that private equity firms register with and report financial data to the Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940, as required by provisions of the Dodd-Frank Act.

The registration of private equity firms as proposed by Dodd- Frank will not accomplish the Act's stated purpose of helping identify and reduce systemic risk in the U.S. financial system. But it will impose an undue burden on private equity firms – especially small and mid-sized firms – in terms of both money and time. And that will divert scarce resources from buying and building small and mid-sized companies – the engines that drive job growth in the United States.

The most important thing to understand about the private equity business model is that we invest in businesses and people – not publicly-traded securities. Private equity firms only make money for their investors and partners when the companies they acquire grow, increase earnings, create more jobs and become more successful. That's good for investors – and for us – but it's also good for the companies in which we invest, their employees, and the communities in which they operate.

I would like to tell you a story about what we do in hopes that you will see that the private equity business model, especially for firms doing private deals in the middle market, simply does not pose systemic financial risk.

Commonwealth Laminating and Coating (CLC) is a small company based in Martinsville Virginia, a town that for many years depended on furniture and textile manufacturing to support its economy. In recent years, both industries have been hit hard by a changing global economy.

CLC manufactures solar control window films that help shield cars, houses and commercial properties from the sun's heat. Its products are sold all over the world − and they all are manufactured in the company's state-of-the-art Martinsville facility. In Martinsville, CLC is a shining star.

In 2006, Steve Phillips, CEO of CLC, realized that he needed much more capital to continue to grow his company. His existing shareholders simply didn't have the necessary funds. Riverside was approached as a potential capital source and acquired a majority ownership interest in CLC in April of 2006. Beginning in mid-2008 and continuing throughout 2009, at the height of the recession, Riverside and CLC together invested an additional $16 million in capital to significantly boost the company's production capacity. A key component of this capital investment program was a new dyed film line that improved product quality and strengthened the company's competitive position. Together, we grew jobs by 73%, adding 61 jobs in Martinsville. CLC also participated in Riverside's strategic sourcing program which enabled the company to reduce its costs on such things as shipping and telephony by about 16%.

By the time Riverside sold CLC last summer, the company had grown its earnings by 277%. The teachers, firefighters and government employees whose pension funds invested in Riverside also received a significant return.

The bottom line: With the help of Riverside's capital, investment management expertise, strategic sourcing programs and a great CEO, this small company in Martinsville, Virginia nearly quadrupled its earnings during the 4½ years it was owned by Riverside. This is what Riverside and firms like us do every single day with thousands of companies, whether it's

Veritext, a very successful court reporting company in Florham Park, New Jersey or Momentum, a fabric distributor to commercial furniture manufacturers in Irvine, California.

Let’s look at the CLC investment through a different lens. Let’s suppose the CLC investment hadn’t turned out as well as it did. Could a failure there have created the type of cascading losses that caused the recent financial crisis? The answer is a resounding “No.” That simply is not possible.

Why? Investors in private equity funds are in it for the long term. They commit capital over a ten-year period and they generally have no right to pull out their money – so called redemptive rights – except in the case of gross negligence. Even then, the fund in which they have invested must be wound down in an orderly fashion.

Even if the CLC investment had not been successful, Riverside would not have been forced to sell other assets into a down market to fund investor redemptions. The impact from a CLC bankruptcy would have been on only one loan. There could not have been a “run on the bank” – the type of scenario that drove Bear Stearns into liquidation. Certainly the bank that lent us the money to buy CLC could have lost money – but Standard & Poors data shows that the average gross leverage ratio for private equity-owned companies is about 4 to 1. Lehman Brothers, in the year before it went bankrupt, was leveraged at nearly 30 to 1, according to Lehman’s own internal analysis.

At Riverside, the average leverage ratio for our companies is well under that for the S&P 500 index of large, publicly-traded companies. In 22 years and across 136 acquisitions, senior lenders in Riverside's deals have lost money only four times. Our senior loan loss ratio is less than ½ of 1%. That, by the way, includes the impact of the Great Recession – surely not enough to "break the bank." Viewed from another perspective, banks simply won't lend to PE firms who lose money frequently. It's bad business.

Furthermore, our transactions are not interconnected with other financial market players, or in a manner such that they are related to each other, there is no cross collateralization and no cross default – each transaction stands on its own.

You also might wonder "What about the private equity fund itself? What kind of leverage is involved at the fund level?" Private equity buyout funds generally do not take on leverage at the fund level, other than short term-loans to fund future capital calls of investors to help with timing the closing of a transaction. And the parent companies of private equity partnerships generally have little or no debt either. As a result, private equity buyout funds do not face margin calls from creditors or unsustainable debt burdens regardless of how their underlying investments perform.

And, even if investors lose money on one transaction such as CLC, they are investing in a fund with many investments, which ensure a diversified portfolio.

Let me give you an example. One of our funds, Riverside Capital Appreciation Fund 2000, invested in 21 companies. Two of those 21 companies failed. Despite those two failures, each dollar invested in that fund returned $2.10 to our investors.

This is not the Wild Wild West. Our industry is closely watched and heavily scrutinized by a very sophisticated group of investors. Private equity investors generally are large, very sophisticated pension funds, foundations and endowments. They allocate small percentages of their assets – typically around 5% and almost always less than 10% − to this less liquid but higher-yielding asset class. They use consultants and advisors to set and manage their allocations and to select the best private equity managers. Darwin would be pleased – only the fittest get funded and survive.

Investments in private equity funds are negotiated with the private equity fund manager, not sold to the public. Private fund investors typically are represented by experienced legal counsel. They also are organized into the International Association of Limited Partners (ILPA), which has issued industry standards for economics, governance rights and financial reporting. Virtually all funds have an advisory board of investors who provide additional oversight. State laws provide fiduciary and other protections to investors. To the extent that a private equity investment adviser uses a placement agent to sell funds, SEC and FINRA oversight applies.

What about protection for those who buy companies *from* private equity firms? When a private equity fund decides it is time to sell an investment, the sales process takes one of two routes. One is an Initial Public Offering ("IPO"). There is substantial legislation providing investor protections related to an IPO that already applies to private equity IPOs. The second route is a private sale to a strategic or financial buyer where extensive due diligence is performed by the buyer. Because of this kind of scrutiny on exit, there is no systemic risk created by these privately-negotiated transactions.

Private equity has been around almost 50 years. It has survived at least three major cyclical downturns and has flourished precisely because of its ability to deliver superior risk adjusted returns. In all these years, how much time has the SEC or this committee had to devote to worrying about negative macro-economic impact or investor fraud in PE? I think the answers to both of those questions speak for themselves.

So now, let's look at what would have happened in the CLC example if the proposed registration and reporting requirements had been in place.

When we purchased the securities of CLC they were stock certificates prepared by our attorneys. On the back of these securities, written in large capital letters, was a notice that they cannot be traded and are restricted. If someone found them on the street they would be worth nothing. So we placed these stock certificates in a vault in our attorney's offices, for which there is no charge. Under the proposed registration and reporting rules, we would need to hire, and pay a third-party custodian to hold on to these restricted, untradeable securities. Some firms charge up to $50,000 a year for this service. This seems like a tremendous waste of time and resources.

What about valuation? Most private equity funds are required to report their fund valuations according to generally accepted accounting principles (known as U.S. GAAP), with valuations performed under the guidelines of FASB rule 157. Under these guidelines, our investors require us to value our portfolio companies every quarter with an audit by a nationally recognized accounting firm done annually.

Valuing private companies – where there is no publicly-traded stock – is an art, not a science. It is challenging and it is expensive. There is no exchange or ready market where an accountant can determine how much a buyer would be willing to pay for the company. In fact, there generally is no agreement between two buyers on what the company is worth. Bids from buyers vary greatly.

According to our understanding of Item C in Section 1 of the proposed new reporting form PF, all private equity firms would be required to calculate the value and performance of each of their funds on a monthly basis. Smaller firms would be required to report those monthly numbers once a year, while firms with assets of $1 billion or more would have to do so on a quarterly basis. To accurately calculate the valuation of each fund, the SEC would, in effect, be requiring that we calculate the value of each company in which the fund has invested on a monthly basis.

That means that under the proposed registration and reporting rules, Riverside would need to hire a compliance officer to certify the valuations of our tiny companies to the SEC. That is in addition to the two national accounting firms assisting us with our GAAP valuations. You can do the math – 50 companies times 12 months means we would have to undertake 600 separate valuations each year to comply with the regulation.

Members of the Association for Corporate Growth, who comprise only a portion of the PE world, estimate that they have invested in 20,000 small and middle market companies. Under the new rules, just this small group might need to calculate 240,000 company values each year. It is hard to imagine that the SEC will have either the knowledge or resources to evaluate these calculations in a way that would help protect the financial system from a systemic collapse. And by the way, the estimated annual costs per firm of this exercise ranges from $500,000 to $1 million or more, according to comments filed with the SEC. Some firms simply will not be able to afford the expense.

There are other implications. At our firm, we operate an ongoing education program for the senior officers of our portfolio companies. We call it Riverside University. Operating it costs us several hundred thousand dollars each year.

Two weeks ago, as part of that program, we hosted a procurement webinar for our small companies. About 70 people dialed in to learn about better ways to manage and buy inventory. Next month, instead of developing plans for another useful course for our portfolio company executives, I will need to spend time looking at a150-page compliance manual designed to help control a set of risks which don't really seem to exist. I'll also have to begin building a budget to implement that compliance program and will have to decide where that money will come from.

It would be a much better use of Riverside's time and resources to help our portfolio companies grow and create jobs than to spend time and money building a compliance infrastructure to solve a non-existent problem.

We believe that the Dodd-Frank registration and reporting requirements for private equity would have a devastating impact on the private equity community, especially on the smaller firms. We believe it will not do anything to help prevent the next financial crisis.   Even if the costs to the industry are viewed as an insurance premium against risk, we believe the “insurance premiums” would be better spent creating jobs, growing companies such as CLC and generating high returns for the public and private pension funds that invest in these companies.

Private equity exists in large part because the public equity markets do not do a good job of serving the capital needs of small companies – the companies that generate the most job growth. America led the way in the founding of private equity and remains the largest and most advanced private equity market.   Instead of imposing additional costs and regulatory burdens, we should be celebrating this American innovation and supporting a system that has steadily provided critical capital to small and growing businesses, thereby strengthening companies and communities and creating more jobs.

Thank you for your time and consideration.

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United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Pamela B Hendrickson	The Riverside Company
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☒ No	☐ Yes ☒ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: Pam B H	

Please attach a copy of this form to your written testimony.