

GP Profile: Pine Brook Road Builds Stable of PE Hybrids



By Bernard Vaughan

05/05/09 Buyout shops stymied by the credit freeze may want to cast an eye over toward Pine Brook Road Partners, a New York-based firm that recently raised \$1.43 billion to pursue investments that combine elements of buyouts, venture capital and growth equity.

The firm's deals start with a management team and an idea for a start-up company eager to carve a niche in either financial services or energy, according to founder Howard Newman, former vice chairman of Warburg Pincus. Next Pine Brook Road executives and management reach an agreement on how much equity the company will need, typically in the \$100 million to \$200 million range, to be self-sufficient, or no longer in need of outside capital.

Pine Brook Road then seeds the enterprise with an initial drawdown of, say, \$20 million, to build out the company's management team and begin executing its business plan. Pine Brook Road executives monitor the company's progress and determine at key junctures whether to allow the company to draw down on its "line of equity," or to pull the plug should performance not suffice. The goal is for the company to reach the point where it can fund capital needs with its own cash flow or through debt financing if appropriate.

It's tempting to call the agreement Pine Brook Road executives reach with management a commitment, but executives say that would be misleading. As the business grows, the firm maintains the option of investing more of the agreed upon amount, based on the company's performance. By the same token, Pine Brook Road executives can cut their losses if they don't like what they see. So far, Pine Brook Road has written equity checks of around \$250 million to nine companies, and its executives expect the portfolio companies to draw down about \$750 million over the next few years. Of the nine investments Pine Brook Road has so far made, eight are start-ups.

The firm targets investments in financial services and energy in part because the start-up costs tend to be so high. Management teams operating in those markets have fewer options for bootstrapping deals themselves. In financial services, the firm invests in property, casualty and specialty insurance and reinsurance, life and health insurance, banks and thrifts, and asset management. In energy, Pine Brook Road tackles oil and gas exploration, oilfield services, and midstream transporting of natural gas.

Though Pine Brook Road is typically a control investor in its deals, the firm (and in some cases co-investors) currently holds stakes as low as 23 percent and as high as 80 percent in portfolio companies. Those stakes do not change over the life of the investment. However, if a co-investor

decides not to fund a capital call then it will naturally suffer dilution. Management in the firm's portfolio companies hold stakes of as much as 15 percent.

The firm doesn't use debt in the initial investment—an obvious virtue in our times like these. However, once portfolio companies have established predictable cash flow, they may borrow money to finance capital expenditures. After one of Pine Brook Road's energy portfolio companies has found oil, for example, it may issue debt securities to help finance the development of those reserves. President and CEO Newman said that under ordinary circumstances, portfolio companies would not use proceeds from debt financing to make payments to existing investors. A key upshot of such an approach is to take out the financing risk from the start-up companies. Said Newman: "We take ideas, management and money and enable management to de-risk their business plan."

The firm anticipates owning its companies for five to seven years, and targets returns of 3x invested capital. It closed its debut fund earlier this month with backing from such investors as New York State Teachers Retirement System and the University of California.

Genesis

Newman founded Pine Brook Road in 2006, after a 22-year career at Warburg Pincus during which he led investments in 47 companies and oversaw the investment of \$3.3 billion across a number of funds.

Not surprisingly, Pine Brook Road's approach to private equity marks an extension of Newman's experience at Warburg Pincus. Starting in the late 1980s, Newman employed the "line of equity" structure with about 20 of the 47 investments he led at Warburg Pincus, mostly for start-ups or newly formed businesses.

Newman's 13-person team at Pine Brook Road boasts years of experience, and bulging rolodexes, in financial services and energy. The team includes Arnold Chavkin, a managing director and former CIO of JP Morgan Partners (then the bank's private equity division) from 2002 to 2006; Joseph Gantz, a managing director and COO with a background as a CEO and chairman of various companies who has worked with Newman on several deals; Robert Glanville, a managing director and former protégé of Newman's at Warburg Pincus who helps oversee financial services investments; Craig Jarchow, a managing director and former director at energy-focused buyout firm First Reserve Corp.; Michael McMahon, a managing director who helps manage energy investments and who introduced Newman to management at four companies Warburg Pincus backed; and William Spiegel, a managing director focused on financial services investments and former president of The Cypress Group, a New York-based private equity firm.

Portfolio company Common Resources LLC, a Houston-based oil and gas exploration start-up, offers a good example of how Pine Brook Road executives tap their collective network to find experienced managers to create companies. Roger Jarvis, the company's CEO, helped Newman and McMahon in 1996 found Spinnaker Exploration Company, a Houston-based oil and gas exploration and production company that Warburg Pincus sold for \$2.6 billion 2005. Elliott Pew,

Common Resources's COO, had retired from Newfield Exploration Co., another E&P company in which Newman led an investment in 1990. Pew, who was in charge of exploration at Newfield Exploration, came to Pine Brook Road in 2007 with plans to exploit energy reserves he had identified on the Gulf Coast and in West Texas. In September 2007, the firm led an investor group that will invest as much as \$500 million in Common Resources. Firm executives declined to discuss how much of that has been drawn down.

Newman likes to think of Pine Brook Road's strategy as consistent with the early purpose of the private equity industry, which he sees as providing a source of unleveraged financing. The industry's use of leverage to juice returns over the last 25 years or so is aberrational, he believes. "There's nothing novel about what we do," Newman said. "We refer to it as back to the future."