Here's a Private Equity Strategy for the Times

07/01/09 Pine Brook Road Partners LLC, a New York-based private equity firm that closed its first fund in April with total capital commitment of $1.43 billion, employs an appealing model in a world gripped by deleveraging fever: it doesn't use leverage to generate returns.

"It's not about financial engineering but about building businesses," Chief Executive Howard Newman told Dow Jones Newswires in an interview. "It's very different from the way private equity has evolved in the last 15 years."

Instead of buyouts, the firm focuses on starting new companies by injecting equity. It takes out risk, rather than piling it on.

"In regular private equity, you are taking capital out of the company," Newman said. "We will be providing capital to fix things." Things such as a bank's balance sheet.

Newman, a former vice chairman of private equity pioneer Warburg Pincus LLC, is no stranger to private equity or to this no-leverage strategy, having been in the business for more than two decades. The PE veteran started the energy and financial services group at Warburg Pincus, where he worked on such investments as Mellon Bank Corp. and Dime Bancorp Inc.

Pine Brook focuses on two of the day's hottest sectors – energy and financial services, both of which Newman believes require additional capital.

Indeed, the U.S. bank sector is still distressed and will require tremendous amounts of capital to retool. While capital markets can handle the needs of the larger banks, smaller outfits such as those with less than $10 billion in assets will likely have to look elsewhere.

In energy, more supply needs to come on line. Oil prices are trending upward again, with crude trading back around $70 a barrel, fueling mergers and acquisitions.

Of course, there's a reason leverage is alluring – it boosts returns. Without the addictive leverage drug, shops have to contend with lower returns or work that much harder to generate similar performance.

Pine Brook is targeting 3x invested capital, and its hold time tends to be longer, at five to seven years, than traditional buyout shops since it is building the businesses rather than flipping them.

In another area of difference, unlike traditional private equity deals where the investment is made upfront, Pine Brook invests its money over time, chipping in only a portion of its investment initially and then providing additional capital as the business grows. The firm targets investments of $100 million to $200 million, in which the first check might be $5 million to $10 million.

Because of these atypical attributes, Pine Brook's fund raising wasn't a piece of cake. The firm started its effort in 2007. "When you are doing something different, it always takes more time," Newman said.

In any case, it's no small feat to close a fund during a challenging money-raising period. In 2009 through May, PE funds raised only $43.1 billion compared with $107.1 billion in the same period last year, according to data from Dow Jones Private Equity Analyst.

Pine Brook is actually doing deals, a rarity in this climate where most private equity shops have been sidelined. According to Dealogic, financial buyout deals plunged 83% in the first half of this year. And that's down from a tepid 2008 deal period.

Pine Brook and its financial partners last month committed $500 million of equity to launch Essent US Holdings Inc., a start-up mortgage insurance company. Newman said the deal took about 18 months. In 2008, the firm saw the continued decline in housing and concluded that prices would fall another 30%. When that happened, they pulled the trigger.

It's good to be in the right place at the right time.