Privcap/Presents

A Conversation With
J. Christopher Flowers
J.C. Flowers & Co.

With insights from:

Grant Thornton LLP
Debevoise and Plimpton LLP
And featured charity:
J.C. Flowers Foundation

About Privcap Media

Privcap is a digital media company that produces events and digital thought-leadership content for the global private capital market. Privcap Media offers communications services to market participants.

Privcap is known for its authoritative online video programs and digital reports. Since its launch in September 2011, Privcap has produced dozens of focused reports, and about 800 video programs—mostly in-depth interviews and panel discussions with private investment experts. Privcap's audience has grown to about 8,000 unique visitors each month—a mix of institutional limited partners, general partners, high-net-worth investors and service providers. Each week, Privcap and its sister site PrivcapRE release and promote new content.

Contact

If you are a GP or LP and would like to request an invitation to a future Privcap Presents gathering, please email events@privcap.com

If you are a service provider interested in being a sponsor of a future event and report, please contact Gill Torren at gtorren@privcap.com

About Privcap Presents

Privcap Presents is a series of invitation-only networking events designed to bring together GPs, LPs and other guests. The events are organized by Privcap Media and hosted in partnership with leading professional service providers.

Each Privcap Presents event begins with an intimate, on-stage interview with a notable leader from the private equity industry. A transcript of that interview is used as the basis for a digital report (like the one you're reading now) that is made available to Privcap's global audience. Also included in Privcap Presents reports are perspectives from the event partners, including a non-profit selected by the featured interviewee.

Navigating the **Global Financial Services Industry**

At the March 30 Privcap Presents event, Privcap CEO David Snow interviewed J.C. Flowers & Co. founder and managing director J. Christopher Flowers about the firm's history, how the 2008 financial crisis affected the firm, and how to invest in financial services in these low-interest times

J. Christopher Flowers

Privcap: When did you start investing in the financial services industry?

Flowers: I went straight from college to Goldman Sachs and spent 19 years there, then started my own company in 1998. All we do is invest in financial services. We're one of the largest—maybe the largest—private equity investors in financial services. And until 2008, we had a lot of fun and made a lot of money. In 2008, we did not have a lot of fun and we did not make a lot of money. But the last few years have been better.

You had a front-row seat to the 2008 financial services crisis. Can you describe what that time was like for you and your firm?

Flowers: I did have the most amazing weekend of my life when Lehman Brothers went bankrupt. I was in Japan on the Wednesday before all this happened and got a call from Bank of America, saying, "What we'd like to do is buy Lehman Brothers and split it with you. You take part of it, we take part of it." So we started looking at Lehman Brothers on Thursday morning. I was back in New York by then.

And then on Thursday afternoon I got a call from AIG that said, "We need to see you right away." I met with the CEO of AIG on Friday, and he had this piece of paper he gave me which across the top said, "Monday, Tuesday, Wednesday," and down the side it had the parent company cash position. By 10 days out, it was negative $5B, and by three weeks out, it was negative $30B. That sounded like a problem. So I knew this was going to be a busy weekend.

Starting Friday, we called our friends at Aviance [Capital Partners] saying, "Get over here right away." We started making working investments in AIG on Friday. And then on Saturday, as if there wasn't enough going on, the CEO of Bank of America said, "Forget Lehman, we want to buy Merrill [Lynch]. Can you help us?" Sure, happy to help. It was quite a scene, and everybody knows what happened in the end.

By the way, remember the piece of paper at AIG that I mentioned? I met with [U.S. Treasury Secretary] Hank Paulson on Saturday morning. He was trying to get us to buy Lehman, and I showed him this paper and said, "By the way, are you paying attention to AIG?" He said, "I'm not. Should I be?" And I said, "Well, yes, maybe you should take a look at what's going on at AIG."

What did you learn from all of that?

Flowers: We learned a couple things. One thing—everybody knows this, but we learned it again—is that it made a big difference where we had control. We usually make investments where we have control, but sometimes we don't. But in this kind of crisis, we really did better where we had control,

CONTINUES ON NEXT PAGE

> **"The CEO of Bank of America said, 'Forget Lehman, we want to buy Merrill [Lynch]. Can you help us?' Sure, happy to help."**
>
> –J. Christopher Flowers

because we changed things faster. We put more capital in or changed the CEO—we could do things. But where we didn't, oftentimes the companies were slower to react, and that led to a lot more trouble.

And secondly, the issue of liquidity is always important, but there were stresses on liquidity of companies in the aftermath of the Lehman Brothers weekend that were of a different nature than we'd ever seen before. And so we've not forgotten what that experience was like.

As the crisis was unfolding, what revealed to you that this was a different landscape than existed beforehand?

Flowers: One of the key things that happened was that the wholesale funding markets dried up like never before. And that was something that we had not anticipated that had profound effects.

What are the opportunities for private equity in financial services today, and what do sellers need from your firm besides simply capital?

Flowers: I would say we're the most active we've been in many, many years. That's from a lot of different areas. The United States, not surprisingly, is one of the most active places where we do business, a lot of that entrepreneurial-driven new ideas, ideas resulting from regulatory change, ideas from technological change. And people are looking for capital, but they're also looking for experienced connectivity, regulatory connections, global connections, which we can offer.

The other big area is Europe. Europe, as everybody would know here, has been sluggish, but most sluggish are the markets where we operate, and that in its own way is interesting too, because companies need capital, they need to restructure, they need to change. There's another big regulatory structure burden there as well.

What are the key drivers of disruption in the industry, and how do you position yourself to be on the winning side of that process?

Flowers: One driver is regulatory change. That has been quite disruptive in the last several years. A lot of what's going to happen has happened, and things are starting to settle down, but it provides opportunities in several ways. One opportunity is with businesses that are no longer permitted to be regulated financial institutions. Another area is increasing capital requirements and the need for more capital. And then oftentimes financial institutions are selling good businesses to raise capital for the rest of their business, so regulatory disruption has been a significant factor. Another factor of disruption in our industry has been low interest rates. We have an industry that has normally prospered more in a higher-interest-rate environment. And so many companies in our industry are working through the question of "What does it mean to be in a very-low-interest-rate environment?"

Can you give an example of a specific regulation that has formed an opportunity for your firm?

Flowers: After 2008, 130 banks in the European Union received financial assistance, which is just about everybody. And in many cases, the European Commission required divestitures from these companies because of their state aid rules. For example, KBC, which is the biggest bank in Belgium, was required by the European Commission to divest a company called Fidea, an insurance company in Belgium. The European Commission made [KBC] sell, so we bought [Fidea]. It was a very nice deal.

How has technology affected your industry?

Flowers: In the big meat-and-potatoes part of our business, it's not having that kind of disruptive effect. We own something like 10 banks around the world. Of course, mobile access, mobile transactions, are very popular. Customers want to use their mobile devices, but that doesn't mean that our companies aren't still doing business with them. They're adapting

CONTINUES ON NEXT PAGE

From top to bottom: Privcap's David Snow interviews Flowers; Guests network at the event.

"One driver is regulatory change. That has been quite disruptive in the last several years."

–J. Christopher Flowers

to that. The technological change is very important, but not in the sense of "There's going to be no banks and no insurance companies as a result of technology disruption."

How have low interest rates affected your businesses?

Flowers: We have low interest rates in the United States. We have low interest rates in Europe. We have low interest rates in Japan. When we make investments, we price them in today's interest-rate environment. So we have had many sales pitches where they've said, "If you buy this one, when rates go up you will get rich." We don't do that. We've been doing business in the world champion of low interest rates, Japan, for 17 years. So you can make plenty of money in low-interest-rate environments, but counting on [rates] going up is not something we want to do.

Having said that, if rates do rise in the United States or any of the places we're doing business, that's going to give a tailwind to what hopefully are already good deals. To elaborate, life insurance is an example of a global industry that has been much beleaguered by low interest rates. You have liabilities that have come down as assets. So you've had margin squeezes in the life insurance business, and there's been a lot of activity there. As rates rise, that's going to favor investments in the life insurance industry.

Can you tell us about how you came to invest in Xinxiang Bank?

Flowers: Xinxiang was a fantastic deal. And there's an unexpected lesson I would offer from that: It is the best deal maybe ever done on a financial institution. Was it a secret? Was it done through some network of who you knew? No. I knew about this deal because I read about it in The Wall Street Journal. So what is the lesson? It is looking in places where other people aren't looking. At that time, private equity people weren't thinking about financial institutions. They weren't thinking about Japan. Part of the way we're going to find good deals today is looking in places where other people aren't looking, geographically. It's also by having advantages over other people in gaining regulatory approvals. ■

Expert Q&A

With Grant Thornton

Barry Grandon
Managing Director of M&A Tax Services Division, Grant Thornton

David Weiner
Senior Manager of International Tax Practice, Grant Thornton

When is the best time to prepare to take your business global?

Grandon: While in the startup phase, business owners should think about the company's future global structure. Business owners will often balk at setting up for global expansion early on, because if you're not yet profitable you're thinking, "How do I spend money on legal and accounting fees when I'm not making any money?" However, proper planning at the outset can help reduce tax exposure in the future, particularly with respect to intangible property. The tax implications of moving intangible property outside the U.S. are often significantly reduced when a company has not yet turned a profit as the intangible property value is limited.

What are some of the tax challenges companies face when going global?

Weiner: What everyone is talking about is the OECD initiative on base erosion and profit shifting, or BEPS. BEPS involves multinationals moving expenses to high tax jurisdictions and profits to low tax jurisdictions. The OECD's goal is for income and deductions to be reported in the proper country of incurrence. This boils down to whether the transactions are supported by the requisite substance. An important focus of BEPS involves intangible property. Moving intangible property is relatively easy as compared to moving an operational business line. By moving intangible property to a low tax jurisdiction, payments can be made from high tax jurisdictions for use of intangible property. Provided such payments do not flow back to a parent company under anti-deferral rules, such payments may significantly reduce a multinational company's global effective tax rate.

What can private equity investors do to properly set up a company to go global?

Grandon: What you can do is silo the intangible property or the marks between a U.S. chain and the rest of world. Such silo structures can help a PE undertake a liquidity event in a tax efficient manner. The questions include: what is the impact at the fund level and are the U.S. investors that sit on top of the structure subject to anti-deferral rules that may create phantom income? The U.S. and non-U.S. rules are very complex and need to be vetted thoroughly before your legal structure is put in place. ■

Grant Thornton
An instinct for growth™

J.C. FLOWERS
FOUNDATION

The J.C. Flowers Foundation partners with other funding organizations, governments and local grassroots organizations to solve health and social problems. The Foundation seeks maximum impact from its investments by working with a wide range of partners with expertise and presence in hard to reach areas, or "last mile" communities.
For more information, visit:
www.jcflowersfoundation.org

What is the J.C. Flowers Foundation trying to accomplish?

Flowers: Well, thank you for being able to say a word about what we're up to. Susan Lassen is the head of the J.C. Flowers Foundation, and for 10 years now Susan and I and many others have been engaged in distributing insecticide-treated anti-malaria nets across Africa. We operate in 17 countries, including Nigeria. We've done that in partnership with the Anglican Church, the Episcopal Church of the United States. And we do that in the most remote parts of Africa—little villages in the middle of nowhere where the Anglican Church has a presence.

It has been very fun, very rewarding. Malaria incidences have increased a lot in Africa, but we can get it down to zero; we used to have malaria in the United States. So there are a lot of places where it's been completely eliminated. Some problems don't have a solution. This problem has a solution and is actually not that hard. It's been done a lot of times. So we're hoping to play a small part, along with a lot of other people, in getting it right down to zero in Africa.

The Bill and Melinda Gates Foundation is also very involved in anti-malaria advocacy. Do you bump into that group? And when you do, do you collaborate?

Flowers: They are a titan in our world, and a very important force in, among other things, trying to develop an anti-malaria vaccine. Originally we thought a lot of our efforts and money would be spent buying anti-malaria nets. That's what we do. They actually don't cost a dollar; they cost $1.80. But the Gates Foundation will give them to us. The U.S. government will give them to us. The World Health Organization will give them to us. And what we're spending our money on, what Susan is doing, is training, education, getting them out there, getting them deployed in little tiny places. The Gates Foundation just can't do that. But yes, they're a big and very admirable factor in this.■