The business of making money

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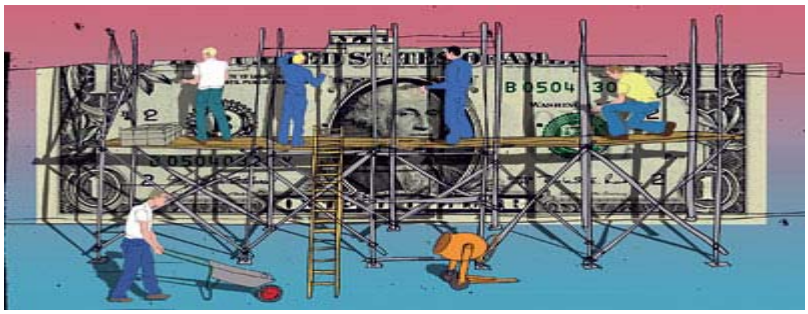

Private equity's strengths and its increasingly apparent weaknesses

BACK in the late 1980s, the *Financial Times* carried a spoof story about a planned buy-out of General Motors. Nowadays the sale of such a giant would not be regarded as a joke. Every day yet another company seems to succumb to the clutches of private equity. And this week saw what could be the biggest deal ever: a $48.5 billion offer by a consortium of investors for BCE, a Canadian telecoms group. It was swiftly followed by a potential $22 billion bid for Virgin Media, a British cable-television company, and the $26 billion purchase of Hilton Hotels.

Even after those deals, the private-equity titans have plenty of firepower left. According to Private Equity Intelligence, a research group, the industry raised $240 billion in the first half of this year, leaving it well placed to surpass last year's record of $459 billion. That compares with less than $10 billion raised in 1991. In the process, private equity's share of mergers and acquisitions has grown massively (see chart).

Private equity has become a byword for money-making skills. “Why are we here attending conferences when we should be setting up private-equity firms?” quipped Niall Ferguson, a historian, at a conference held at the London Business School on July 2nd. But the industry's

wealth has also made it plenty of enemies, with trade unions and left-wing politicians calling for curbs on its activities and higher taxes on its earnings.

The intellectual argument in favour of private equity has not changed much in 20 years. In 1989 Michael Jensen, of the Harvard Business School, wrote a paper* suggesting the public company had outlived its usefulness. Economic developments, in particular the recession of the early 1990s, made that forecast seem premature. But its underlying arguments have more force today.

Public tedium

Life is no longer much fun in a publicly quoted company. Executives have to suffer the slings and arrows of intrusive media coverage, the oppressive tedium of “box-ticking” corporate-governance codes, the threats of activist investors and short sellers, and the scrutiny of single-minded political campaigners.

And what do companies get in return? Traditionally they have had three main reasons to list their shares on a stockmarket. The first is to raise capital, either to expand the business or to allow the founders to realise their wealth. The second is to help retain staff, who can be offered share options as an incentive to stay and work hard. The third involves prestige; customers, suppliers and potential employees may be reassured (and attracted) by the apparent seal of approval given by a public listing. However, all three reasons seem to be less compelling than they used to be.

Historically companies have got their equity capital from four sources: pension funds, insurance companies, mutual funds and retail investors. The first three groups faced legal or regulatory impediments to buying unquoted shares, while the public naturally valued the liquidity a stockmarket listing could bring.

In the absence of a public quote, companies often had only one financial alternative: the banks. In some areas of the world this worked quite well. Banks were reliable partners to Germany's Mittelstand of unquoted companies and to Japan's industrial empires. But in the Anglo-Saxon economies companies often felt nervous about being in hock to the banks. A change in lending policy, due to new management or an economic downturn, could lead to the sudden withdrawal of credit.

Nowadays companies have many more options when it comes to raising money. Banks are much less important as a source of lending; they have been “disintermediated” by capital markets. Banks might arrange loans, but they quickly offload them to outside investors such as hedge funds. Bond markets are much more liquid than they used to be, and thanks to high-yield products even companies with a poor credit-rating can tap them.

Then, of course, there is private equity. It can provide finance at an early stage (venture capital) or as an attractive alternative for companies that have a public quote (the leveraged buy-out). Whereas pension funds will be reluctant to hold a direct stake in an unquoted company, they are willing to pay hefty fees to private-equity firms to invest money on their behalf.

So companies have no difficulty in finding capital outside the public market these days. Just as importantly, in recent years they have had little need to raise capital at all. Corporate profits have risen to a 50-year high as a proportion of America's GDP. Companies have used the cashflow from those profits to buy back shares and pay down debt.

Mr Motivator

In the 1990s it seemed as though everybody in America had a neighbour or a relation who was about to become a millionaire through their stock options. Companies were handing them out like free newspapers on Piccadilly. Company boards were happy to offer options since accounting rules allowed them to pretend they had no cost. Employees were happy to take them in the belief that an ever-rising stockmarket would allow them to buy the condominiums of their dreams. Companies without a listing seemed likely to fall behind in the race for talent.

But the collapse of the dotcom bubble made lots of options worthless. These days many employees would just as soon be rewarded with good old-fashioned cash. And now that options are properly accounted for, companies are just as happy to hand cash over.

Besides, partnerships such as lawyers and accountants (not to mention hedge funds) have historically managed to offer very generous rewards to their top employees without the need for a stockmarket quote. And private-equity groups have also been successful at retaining important staff by offering them potentially lucrative stakes. Indeed, top executives may prefer the private sector. For a start, private-equity bosses can keep what they earn secret, while chief executives of quoted companies find themselves the subject of impertinent comments from the media and activist shareholders.

Perhaps as a result, managers can earn a lot more in the unquoted sector. The most famous example is Dave Calhoun, a top GE executive who turned down jobs at S&P 500 companies for the chance to run privately owned VNU, a Dutch media group, for a reported $100m package.

Of course, such executives will take more risks and work hard for their money; private-equity partners can be tough taskmasters. But at least there will be only one set of masters and the goals will be clear. There is no need to worry about the onerous bits of the Sarbanes-Oxley law (in America), or shareholder resolutions separating the roles of chairman and chief executive (in Britain) or hedge funds demanding that businesses be sold off (pretty much anywhere). Public companies have to reveal a lot more than private ones. Pressure groups can pore over every detail of company policy from the use of child labour to carbon emissions.

The danger is that executives running public companies end up spending so much time dealing with shareholders, regulators and campaigners that they neglect the business. Indeed, these different “stakeholders” may well demand different, and irreconcilable, things. Entrepreneurs, the type of people who like to “get things done” may not want the hassle.

There is another problem, identified by Professor Jensen almost two decades ago. The structure of a public company creates an inherent conflict between investors and the managers they hire to run the business. The main problem is what to do with free cashflow, the money left over after all profitable investment projects have been funded. In theory this money should be returned to shareholders, but managers may be reluctant to do so. Holding on to cash means they do not have to go cap in hand to capital markets.

Professor Jensen argued that borrowing imposed discipline on executives. They needed to generate cash to meet interest payments. And, if they wanted to finance a project, they would have to convince investors that it was worthwhile. The result ought to be fewer unprofitable projects because cash is no longer left burning a hole in managers' pockets.

Private-equity firms apply this lesson in spades. They gear up the balance sheets of companies they buy with more debt than public firms are willing to accept. Nearly 20 years of economic stability have led some to believe that even notoriously cyclical businesses, such as carmaking, can now bear higher levels of debt.

In theory, executives working for private-equity owners respond by cutting costs, weeding out unprofitable operations and expanding those parts of the business where returns are highest. This is what generates charges of asset-stripping. But some of this occurs in most takeovers, whether public or private. Most takeovers are justified by “synergies”, which usually means shedding jobs at head office. This is all part of the “creative destruction” process that allows capital to be allocated more efficiently. Academic studies have suggested that private-equity firms create jobs rather than destroy them, although a lot more research needs to be done before everybody will be convinced.

Workers do have a legitimate concern about the security of their pensions. When a company takes on a lot of debt it undoubtedly makes the “covenant” between a company and its pensions scheme less secure. For a start, it increases the risk that a company may go bust, and so may not be making contributions into the scheme in future. And in the short term executives will concentrate on paying down debt rather than making additional payments to close a pension deficit.

It may well be that the shift away from quoted companies turns out to be detrimental to workers' pensions rights. However, those rights were already being eroded, with many quoted-company schemes being closed to new members or to future accruals for existing employees. Private equity is not the main, or even a leading, cause of the pensions crisis.

The conglomerate model

Another potent criticism of private equity is the parallel with the conglomerates of the 1970s and 1980s, such as ITT, BTR and Hanson. Like private-equity firms, the conglomerates used their financial muscle (in their case, highly rated shares rather than borrowed money) to construct diverse industrial empires. They argued, just as

private equity does today, that they could improve the companies they owned through superior management.

Eventually, those empires fell apart. Like a shark compelled to keep swimming forward to catch its prey, they needed ever-bigger acquisitions to make progress. Investors concluded that they could diversify on their own, by buying shares in different sectors. They did not need a conglomerate to do the job for them.

Private-equity groups insist they will not run into the same problem. “We don't hang on to the businesses,” says the leader of one. But that creates another potential problem: investing for growth. If a business is going to be sold within, say, five years, what incentive is there to approve the financing of projects that may take a decade or more to pay off?

Private-equity bosses maintain that it is not in their interest to ruin the companies they buy, because they want to sell them again. And it is also the case that the executives of publicly quoted companies can sometimes skimp on capital expenditure, given that they are often under pressure to meet quarterly profit targets.

Superior returns?

In the end, the argument comes down to a simple one: if private-equity firms are organising the assets of companies more efficiently, then the founders of the industry deserve their billions (though not, perhaps, all of their tax breaks). But it is hard to measure the efficiency of private-equity firms directly. The best that can be done is to look at their returns. Here, the evidence is murky. One much-cited study** found that average returns, net of fees, were roughly equal to that produced by the S&P 500 index between 1980 and 2001. That implies that private-equity firms do improve the businesses they own, since gross returns outperform the market. But investors do not seem to benefit. “Overall, returns have not been that special, especially if you adjust for risk,” says Richard Lambert, director-general of the Confederation of British Industry, Britain's main business lobby-group.

The calculations can be complicated by the tortuous accounting used to calculate the private-equity industry's returns. A recent study† suggests that the residual values of companies that remain in private-equity portfolios may have been overstated. Allowing for this cuts the average net return to three percentage points below that of the S&P 500 index.

However, analysis does suggest that a small proportion of private-equity groups has consistently achieved superior returns. And a study by three American academics†† found that the results achieved by end-investors (such as pension funds and private banks) differed widely; college endowments earned returns that were 14 percentage points better than average. This suggests that a headlong rush by pension funds into the sector in pursuit of diversified returns from “alternative assets” might leave many disappointed.

Going private

Could the private-equity model become the norm, replacing the public company? And would that be a good thing? What might be logical for an individual company might not be best for the economy overall. If all companies were to substitute debt for equity on the scale that private-equity firms have, there would be an increase in the cost of debt. That would make superior equity returns hard to achieve.

In addition, private-equity firms need an exit route to sell their investments. Although there is a growing trend for secondary deals, where one group sells a firm it has bought to another, there must be a limit to which further efficiencies can be squeezed out of any particular business. In the end, a public market will be needed for someone to realise their profit.

Indeed, the need for an exit route was neatly demonstrated by the recent flotation of Blackstone, one of the largest private-equity groups, on the New York stockmarket and the decision this week by Kohlberg Kravis Roberts, another of the industry's titans, to follow suit. It does seem a bit hypocritical for these firms, who regularly tout the benefits of the private model, to head for the public markets—but what other route could they take? They could hardly agree to be bought by each other.

A bigger role for private equity might make the economy more vulnerable. Historically, recessions have often occurred when rising interest rates have cut into corporate profits, causing firms to slash employment and capital expenditure. In a world where most companies carried private-equity-style debt levels, companies would be much more vulnerable and recessions might become much more frequent. Monetary policy would become more difficult, with even small changes in interest rates having the potential to cause massive damage to business. And government revenues might be affected if large portions of industry were financed by tax-deductible debt.

But private equity still accounts for only a small proportion of corporate ownership. Much of the industry's activity is among small and medium-sized companies. There is still plenty of scope for private-equity firms to expand.

It may well be, however, that the peak of the cycle is close at hand. Private equity is inevitably a “feast and famine” business: when one fund can raise a lot of capital, they all can. Competition to buy companies then pushes up the price of doing deals, increasing the interest burden and reducing the returns for equity holders. More deals will be done this year, but they may not deliver the kind of returns that investors are hoping for, just as the late 1980s buy-out of RJR Nabisco, the emblematic deal of the era, proved a disappointment.

Since 2003 conditions have been almost ideal for private-equity firms, with low interest rates, lots of liquidity and rising asset prices. But recent events have been moving against them. Bond yields have been rising, making takeovers (which replace equity with debt) more expensive. The high level of corporate profits suggests that there may not be much more to be wrung out of businesses. And the relentless campaign against private-equity tax privileges has made the groups look like easy targets for finance ministers. It may be symbolic that Blackstone's shares quickly slid below the offer price.

Bad debts

Investors also seem to have woken up to the potential risks, perhaps alerted by the losses being suffered in another part of the credit universe—subprime mortgages. They had previously been happy to extend credit on easy terms, such as "covenant-lite" loans (debts with few checks on operating performance) or payment-in-kind notes, where borrowers can substitute more debt for interest payments. Now they are starting to turn down deals where private-equity firms push their luck too far. Banks are getting reluctant to provide the "blank cheques" that private-equity groups were demanding for the bridge financing of deals. In addition, exits may be becoming more difficult: the sale of New Look, a British retailer, collapsed when the last two remaining bidders pulled out.

It is important, however, to distinguish between the cyclical and structural tides. The 1980s private-equity boom ended in the face of rising interest rates and a slumping economy. The same combination might cause another retreat over the next few years. But after that tide has ebbed, more businesses will be in private hands. And when interest rates inevitably fall again, the private-equity wave will once again capture new ground.

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*"Eclipse of the Public Corporation", by Michael Jensen, *Harvard Business Review*, Sep-Oct 1989

**"Private Equity Performance: Returns, Persistence and Capital Flows", by Steven Kaplan and Antoinette Schoar, *Journal of Finance*, August 2005

†"The Performance of Private Equity Funds", by Ludovic Phalippou and Oliver Gottschalg, April 2007

††"Smart Institutions, Foolish Choices? The Limited Partner Performance Puzzle", by Josh Lerner, Antoinette Schoar and Wan Wong, MIT Sloan Research Paper 4523-05, January 2005