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Private Equity: Leveraged Expertise or Leveraged Bets?

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Private Equity: Leveraged Expertise or Leveraged Bets?

1. What is private equity?
2. Why is it controversial?
3. Why could private equity be good for society?
4. Latest evidence on value creation / destruction
5. Latest evidence on what drives buyout leverage
   – Too much debt?

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Buyout fundraising (U.S.) as % of market

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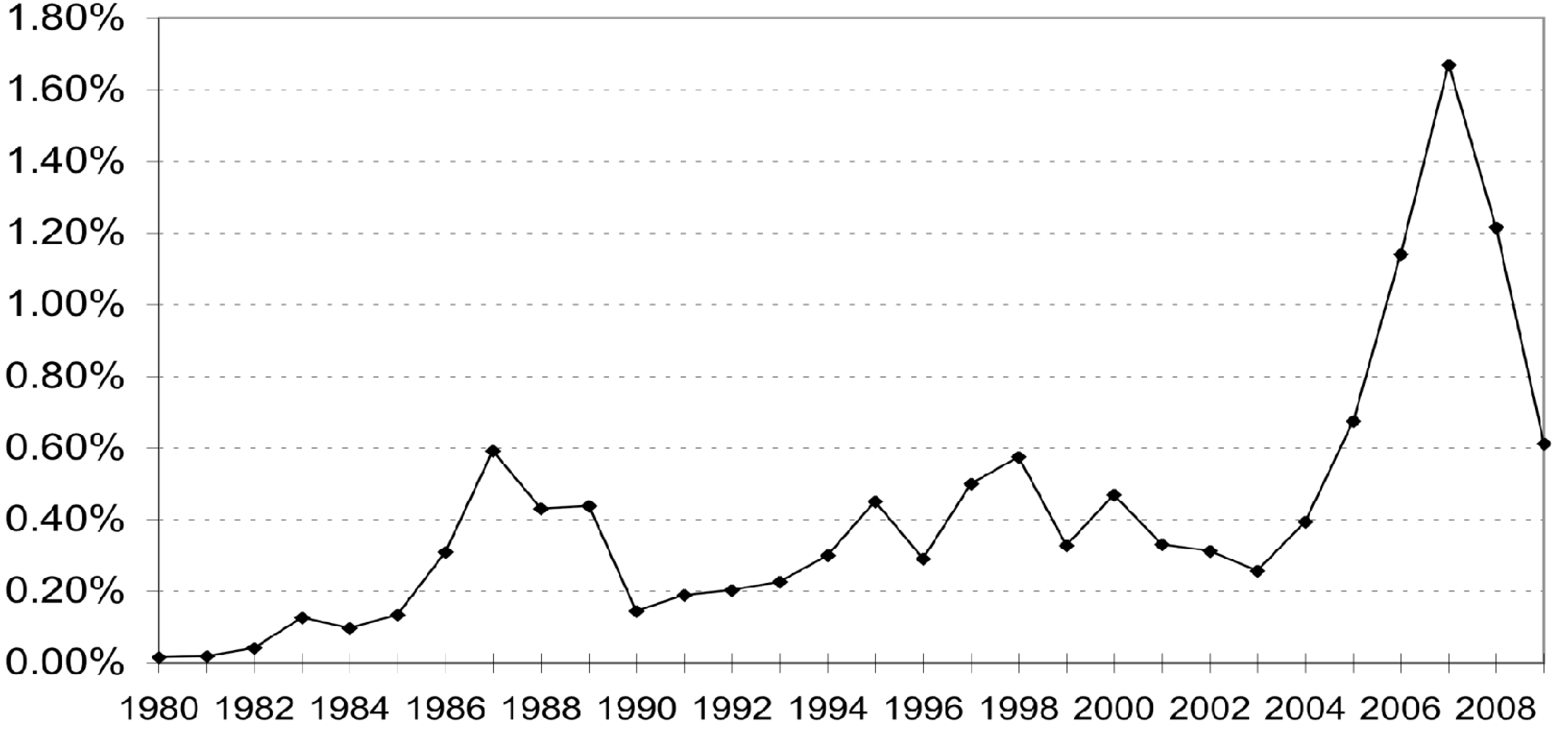
Commitments to Private Equity Partnerships in U.S.
as fraction of boy stock market capitalization 1980 - 2009



Source: Steve Kaplan, Venture Economics

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What is Private Equity? The ”Standard” model

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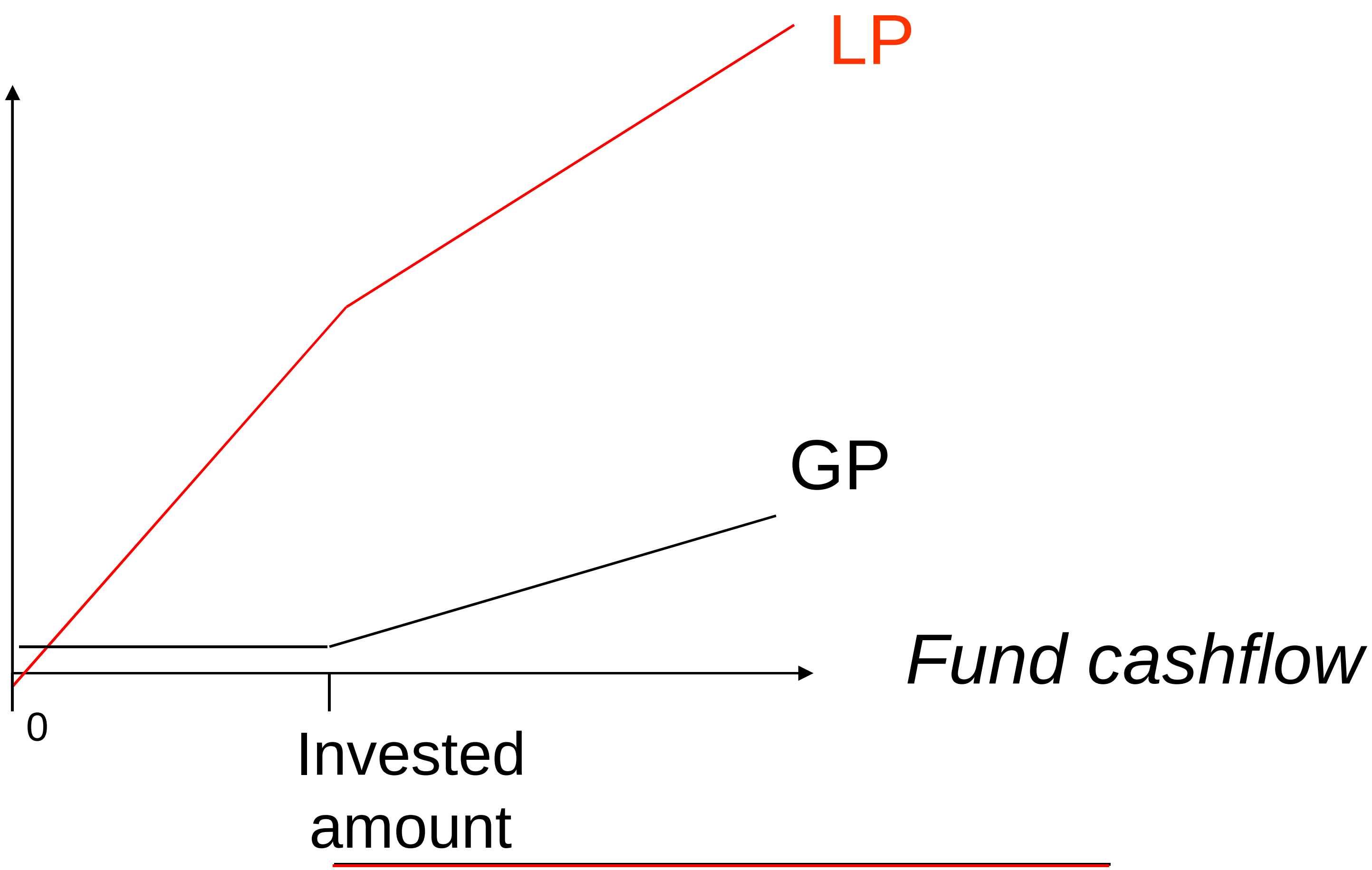
1. ”General partners” raise a fund of ”blind” money from ”limited partners” (LPs)

2. GP invests by buying listed and unlisted companies, using fund money + debt
   – ~30% equity from fund, 70% debt
   – LPs have no veto rights

3. Exit within 10 years through IPO, trade sale, secondary, liquidation

- Proceeds split using ”2-20” rule:



The argument against buyouts

1. Too much leverage:

“in order to produce ever higher returns, private equity firms have increased the risk of bankruptcy, which always generate public costs.”

2. Asset stripping, destroying firms:

“We know that acquisitions of target companies by private equity funds have, in many cases, a detrimental effect on employment, research & development and investment.”

3. Short-termist, too shareholder oriented:

“the risk is to have undue wealth transfers from employees to shareholders, on the one hand, and short term decisions affecting long term value, on the other hand. Both would constitute negative externalities, which call for special attention.”

Poul Nyrup Rasmussen, MEP, chairman of PES, drafter of AIFM proposal, London Sep. 2, 2009

The argument for buyouts

The LBO is a superior organizational form.

Michael C. Jensen (Harvard Business Review 1989),
"The Eclipse of the Public Corporation"

Can PE be good for society?

- Key problem in financial economics:
  - Channel resources from people who have them to people who can put them to the most productive use.
  - Obstacles: *information problems* and *moral hazard* problems.
- In public firms, dispersed shareholders have little incentive or means to gather information and monitor management.
- Private family firms bear too much risk and may not be best suited to run firm.

- Private equity solution with strong, expert, informed owners.
  - Small, informed, boards that monitor closely
  - Import good management practice to companies

- Debt provides:
  - Leverage of expertise across more investments.
  - Disciplinary effect on managers.

But who monitors the monitor?

Who monitors the monitor?

- PE fund structure aligns GP-LP incentives *(Axelson, Strömberg, Weisbach (2009)*:
  - Profit sharing gives incentives to choose right investments and monitor them
  - Profit sharing on pool instead of single deals avoids gambling
  - Need to raise debt for each deal gives market check
    - » Banks as gate-keepers
- Ownership term limits give:
  - Focus and urgency (call to action)
  - Incentives to perform because track record affects future fundraising

Do PE investors add value to the companies they finance?

- Accounting studies quite positive:
  - 80's US public-to-privates show big improvements. *(Kaplan (89))*
  - Confirmed in studies on European & Private deals
  - Later US P2Ps improvements, but smaller. (*Guo, Hotchkiss, Song (2010))*

- Evidence of positive spillovers:
  - 80s LBOs led to better governance in public firms.
  - Bernstein et al (2010): cross-country, cross-industry study.

Is this at expense of workers, long-term investments?

- Employment *(Davis et al (2009))*:
  - Both more job creation and more job destruction.
  - French study more positive *(Boucly, Sraer, Thesmar (2009))*.
- R&D *(Lerner, Sorensen, Strömberg (2010))*:
  - No decline in patenting, more efficient patenting.
- Reverse LBOs outperform market post-IPO *(Cao and Lerner (2009))*:
  - Changes are not temporary.

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Does value added make buyout investors rich?

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- PE returns somewhat *below* S&P500 returns (*Kaplan and Schoar (2005))*
- Value added from private equity goes mostly to:
  - Target shareholders
  - GPs in fees

Is buyout leverage too high?

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- Buyouts have on average 70% debt, public co's 30%.

- Does this put companies, workers, the economy at undue risk?

The positive role of leverage

- Leverage is an integral part of value creation:
  - Helps GPs leverage expertise
  - Improves CEO incentives
  - Debt markets as external gate keepers
- PE funds cope better w. high leverage than other owners:
  - Repeat players in debt markets, better at renegotiating with banks.
  - Informed owner who can inject more equity if company worth saving.

The negative role of leverage

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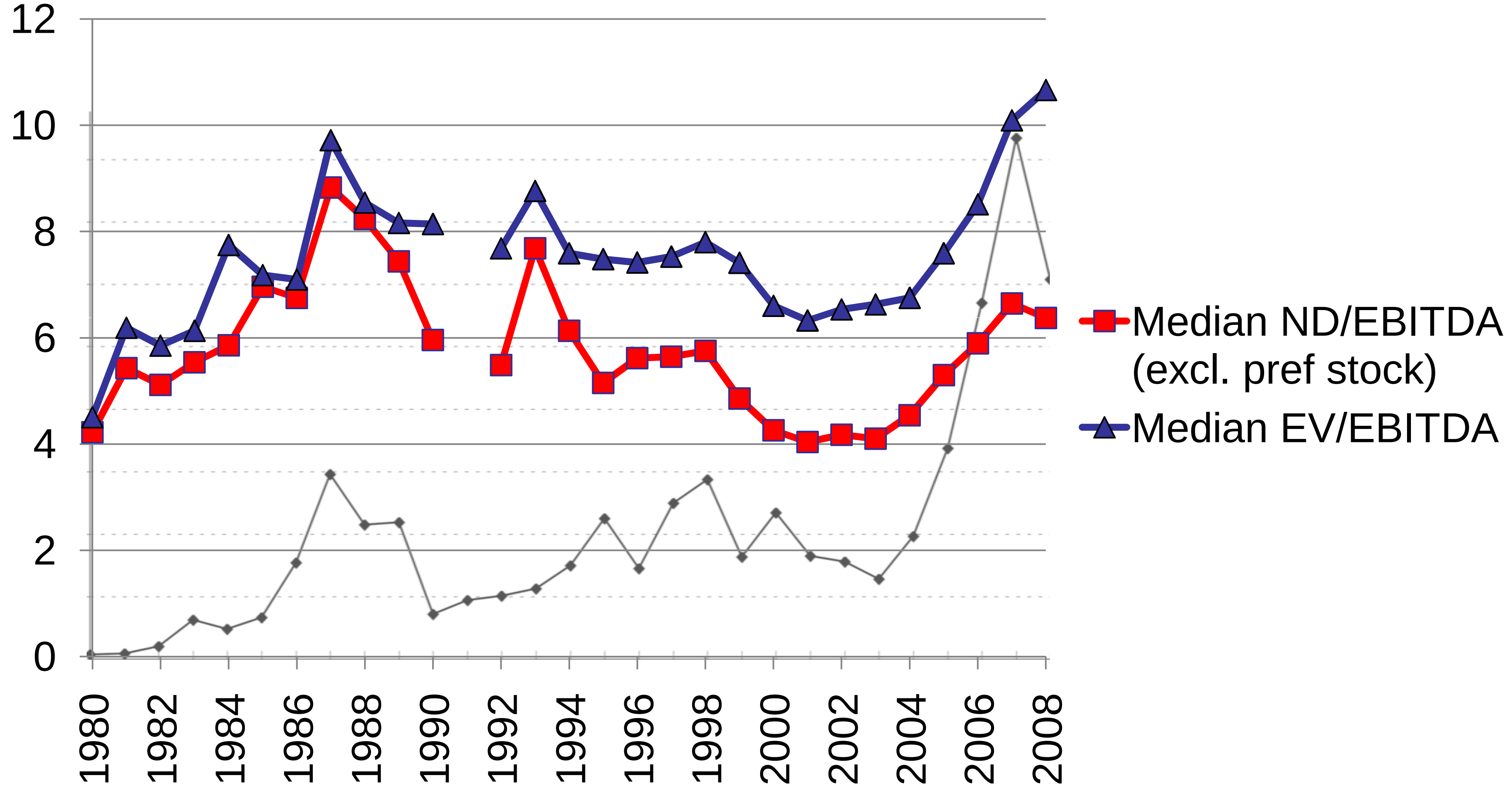
- If providers of debt do not screen properly, external discipline gone

- GP takes part of upside profits but LPs carry downside losses:
  - Gives incentive to take ”levered bets” when debt markets allow
  - Internal discipline gone

➔ Leverage mostly determined by easy access to debt, not what is most suitable for company

Buyout leverage, pricing and activity driven by credit booms



Source: Axelson, Jenkinson, Strömberg, & Weisbach (2010)

- We find that funds taking on *unusually* high leverage have significantly *lower* returns (IRRs).

- Most consistent with "levered bets" story for leverage when debt markets are booming:
  - More liquid debt markets → higher leverage → higher transaction prices → lower returns

- Solution?
  - Regulate providers of debt to avoid excesses
  - Make very highly levered deals subject to LP approval?

Are we likely to see costly defaults going forward?

- Big ’05-’07 cohorts have yet to be exited.

However:

- After 80’s boom, even defaulting firms were in better shape than before buyout. *(Andrade and Kaplan (1998))*.

- In latest boom, debt terms considerably looser.

Conclusion: Buyout market

- The Private Equity model has proved itself:
  - Enhanced performance without sacrificing workers, long-term investments

- Activity sometimes too reliant on credit markets.
  - Unlikely to pose systemic risk.

- Relative to boom, will have fewer and smaller funds, using less leverage.

- The model will endure because it makes sense.

- Thank you!