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Agenda

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Private equity: new kings of capitalism?

Against a background of some high-profile takeover activity, private equity has been subject to considerable scrutiny in recent months. Tim Jenkinson, Professor of Finance at Saïd Business School and Oxera Director, explains what private equity is, and considers whether it can add value

Although increasingly important in all the major economies, private equity is a sector that many people still know little about. This is not surprising. The amount of public information about the transactions, performance and activities of private equity funds is limited. But the amount of money raised by private equity funds over the past few years has been enormous. In 2006 alone, more than $400 billion was raised by private equity funds and, for reasons explained below, their buying power is two or three times higher than this figure. Private equity funds are increasingly looking at large companies, many of them publicly quoted, as potential takeover targets. The way private equity firms manage funds differs significantly from the traditional public company model, and has led some to question whether private equity is a new and superior form of corporate governance.

This article lifts the veil on the private equity sector and looks at whether those who work in private equity are really the new kings of capitalism.[1]

What is private equity?

Definitions differ, but in discussing private equity, this article refers to the entire asset class of equity investments that are not quoted on stock markets. The private equity class therefore stretches from venture capital, working with early-stage companies, which in many cases will have no revenues but potentially good ideas or technology, right the way through to large buyouts where the private equity firm buys the whole company.

In some cases these companies might themselves be quoted on the stock market and the private equity fund performs a 'public to private transaction', thereby removing the entire company from the stock market. However, in the majority of cases, the buyout transactions will involve privately owned companies, sometimes with family ownership or, very often, a particular division of an existing company. Between these two extremes are other forms of later-stage financing such as providing capital to back the expansion of existing businesses. For the most part, this article refers to 'venture capital' and 'buyouts' as the two main forms of private equity.

How is the invested money split between venture capital and buyout deals? In broad terms, around four-fifths of the money has been flowing into buyouts in recent years in both the USA and Europe. In part, this is due to the sheer scale of buyouts where an individual deal can absorb several billion euros of capital. In contrast, venture capital deals tend to drip-feed money into companies as they develop. But it is also because investors have increasingly been focusing on buyout firms, especially in Europe, as the average returns have tended to be higher.

Where does the money come from and who runs the private equity funds? Most of the money comes from institutional investors such as pension funds, endowments and insurance companies, although many high net-worth individuals also invest directly or through fund of funds intermediaries. At present, the proportion of assets allocated to private equity is considerably higher in the USA than in Europe, although surveys of European investors tend to show that the fund managers are aiming to increase their allocation to private equity. Thus, the flow of money is likely to continue and, indeed, grow.

What about the funds themselves? There are many players in this market, but most of the pure private equity funds are structured as limited partnerships. Essentially, they are tax-efficient investment vehicles, which have a limited duration, almost always with a ten-year life. Investors commit a certain amount of money to a fund; the fund then asks the investors to send the money only as they find investment opportunities. These calls for capital take place over the first few years of the ten-year life of the fund.

Buy and sell

A critical aspect of private equity funds is that they are not investors who buy to own the companies for the long term—they are buy-to-sell investors. They want to make their investments, create value and then exit. They are judged according to two measures of performance: the main one is simple cash-on-cash returns. Whatever sums they commit, the investors care about how much they get out, net of all the payments to the fund. A good investment might return three, four or even higher multiples of the original sum invested. Alternatively, the investment may disappoint and return a fraction of the original sum, or in many cases, particularly with venture capital, it may be worthless after a few years.

The second performance measure is the internal rate of return (IRR) that investors achieve, which depends on how long it takes for them to get their money back. Thus a profit achieved in two years will have a higher IRR than if the same profit took four years to achieve. Given these performance measures, a private equity firm has sharp incentives to create value, to exit the investments, and return the money to the investors; the partnership agreements do not let them reinvest the proceeds in the next available opportunity. These are not like mutual funds that shuffle their holdings and return the money only if investors ask for it. Funds have to go out and raise capital again by launching a new fund. If performance has been poor this will not be easy—so most funds, but not all, are organised as limited partnerships.

Remuneration

Another important aspect of these funds is the remuneration of the private equity firm—the so-called general partners of the partnership. There are two components to this remuneration. The first is a percentage fee for managing the fund, which is usually around 2% per annum; it could be higher for successful venture capital firms, reflecting their general smaller size, and might be lower for the much larger buyout funds. This fund is typically paid on the capital committed, not the amount invested, at any one time. So over the ten-year life of a €1 billion fund, the management fees might sum to €200m, and some funds may find ways of increasing this income even more by charging transaction fees to the companies they acquire or by levying ongoing management charges. These annual fees and additional charges can yield very large sums of money, especially when one considers that the funds are extremely lean organisations with few employees and even fewer partners who enjoy a share of the profits.

This profit share is the second part of the remuneration and is referred to as carried interest. The carried interest is typically set at 20% of the net profits earned by investors, and is payable only when the investment is realised and the cash has flowed back to investors. So, if a €1 billion fund returns €3 billion to its investors, the profit would be €2 billion, and the lucky few in the private equity fund who enjoy a share of the carried interest would share 20% of this (ie, €400m).

What of the returns?

Has private equity been a good investment? The answer is perhaps surprising. Any analysis of performance faces a significant problem which is that, while private equity funds have an obligation to report regularly and in detail to their investors, there is absolutely no obligation to make this return information public, and some funds go to considerable lengths to maintain such secrecy, despite the efforts of certain parties such as journalists and academic researchers. The implication of this is that evidence on returns is partial at best, and is likely to suffer from selection bias. Why? Because funds are more likely to reveal their returns to various parties that report and usually sell such information if these returns have been impressive. This is an important caveat to remember when considering evidence quoted on average realised returns to private equity.

Even though the evidence is incomplete and probably biased in an upwards direction, what does it show? Looking at the European market over the last 25 years, it suggests that returns have, on average, been unremarkable and in some cases, downright disappointing. These disappointments have been greatest at the early-stage venture capital investing where, on average, investors have barely received their original investments back. Note also that this measures only cash returns: there is no allowance for inflation or the opportunity cost of not investing in the stock market, or even leaving the cash in the bank earning interest.

However, this average hides the real story, which is that funds differ significantly in their performance—and not just by a couple of percentage points, as would be the case with traditional unit trusts or mutual funds. An interesting exercise is to stack up the funds in terms of their returns and look at the fund which would be ranked at the 25th percentile—very good performance but not some extreme outlier. Within Europe, the IRR on this fund has, on average, been 20 percentage points higher than the corresponding fund that would be ranked at the 75th percentile. Put another way, the latter fund, which is just in the bottom quartile of the distribution, might return a negative IRR of 8%, whereas the former fund, which is just in the top quartile, has returned around +12%.

Furthermore, there is growing evidence that superior performance by particular private equity firms is persistent over time as they raise new funds. Hence, when investing in private equity, manager selection is everything. However, the funds run by successful managers are often vastly oversubscribed, so it can be difficult for investors new to private equity to obtain access.

There is one other problem that investors face. Because it is difficult to obtain consistent and complete information on the performance of past funds, it is difficult to know which private equity firms have actually performed well. There is a joke in the industry that all private equity firms are in the top quartile, and on some particular and selective measure that may be the case. For example, there have been claims along the lines of: 'Our funds have achieved top-quartile performance'—followed by a footnote stating: 'In comparison to all French funds raised from 1995 to 1998 investing in buyouts in Europe valued between €500m and €700m'.

Leaving aside the problems of measuring returns, things look a lot brighter when considering the returns earned by buyout funds. For example, in Europe over the past 25 years, the average returns have been around 10% per annum. The average return of the top-quartile funds has been nearly 30% per annum. Put another way, investors in these top-quartile buyout funds have received back double their money, and these excellent returns have been even more pronounced for the buyout funds that focus on very large transactions. The prospect of these sorts of returns explains why investors are putting more and more of their portfolios into private equity. As you might expect, in recent years the flow has predominantly been into buyouts rather than venture capital.

How do private equity firms add value?

Venture capital

Again, the story is different in venture capital and buyouts. In a typical early-stage company, the venture capitalist is working closely with the entrepreneur, providing not just finance but also mentoring, access to networks, business disciplines, support services and so on. Capital will typically be allocated in tranches and only released if certain milestones or targets are met. So a firm might be given €1m to develop a prototype and only be granted additional funding if this is successfully achieved. The venture capitalists typically sit on the boards of directors, and although not often in overall control, have considerable influence over the company, its strategy and the entrepreneurs. For this the venture capitalists often need industry-specific knowledge—in part to shape the strategy of the firm, but also because their networks can enable collaboration with potential suppliers or complementary firms, which can be critical to success. Many early ventures fail, but the returns are really driven by the home runs, the firms that return 50, 100 or even 1,000 times the original investment. Spotting these from an early stage is a valuable and rare skill, although luck can also play its part.

Buyouts

With buyouts the game is really very different. Buyout funds are looking for existing companies where they could create value. Invariably, the funds buy the companies only partially with their own money and raise the balance as debt finance. This debt finance is initially raised by banks, but only a fraction would actually continue to be held by banks. Increasingly, the debt gets repackaged in the form of complex financial instruments, such as collateralised loan obligations, or is held by investors such as hedge funds.

In a typical buyout deal, the private equity fund puts in around one-third of the money and the remaining two-thirds is debt finance. This is why they are often referred to as leveraged buyouts. The successful buyout firms aim to grow a business, provide clear strategic direction and prepare it to be sold to a new owner within a few years. As mentioned above, these are buy-to-sell investors, not buy-to-own, and the only way to increase the value of the firm is to make it more efficient and competitive; and they are impatient—they want to achieve results quickly, not over decades. Only when they exit do the profit shares flow. So they typically take full control of the company. Unlike stock market-quoted companies where shareholders play only a limited role in the governance and decision-making of the firm, private equity owners are in control and define a clear strategy for the firm. They set tough but realistic targets and keep management focused on them. They establish extremely sharp incentives on management in the form of financial returns if they are successful, and they recruit the best talent to execute their vision. It is effectively a different form of corporate governance.

Rather than being required to publish quarterly results, which are then scrutinised with a fine-tooth comb by analysts, rating agencies and the media, or to generate nice steady profit and dividend growth for investors with no surprises, managers of private equity firms can operate outside the public arena. They are owned by one or sometimes a few private equity funds that set very clear objectives, which might well involve a radically different strategy. In the case of a public company it could be difficult or, indeed, dangerous in terms of alerting competitors, to explain such strategic shifts to all shareholders through public statements. Radical and quick transformation is therefore difficult. Private equity ownership is highly concentrated and is not divorced from control. Incentives are sharp on all sides. Indeed, the financing of the buyouts by debt significantly increases the risk/reward ratio for all sides, as is predicted by standard financial theory. Having to pay the interest on the debt focuses attention squarely on cash flow, which can be a tremendous discipline for management, and by using significant amounts of debt, the private equity funds have to put up less cash to acquire ownership. The same goes for management who would be expected to put in a significant amount of their own money to buy an equity stake in the company. If the deal works and the debt is successfully paid off, the returns to the equity holders can be spectacular. The private equity fund can realise several multiples of its original investment and management may receive tens or sometimes even hundreds of millions of euros. Everyone is happy.

But could this happen in a publicly quoted company? Would investors be prepared for a successful chief executive to walk away with €100m? Is it any wonder that surveys of leading executives increasingly find that private equity-controlled companies are where people want to work? Put differently, private equity is really a different form of governance which is challenging the dominance of stock market-quoted companies.

However, this is not to say that one form of governance is necessarily superior at all times, for all companies. For some firms, life on the stock market may be fine. Strategic direction is well defined, the board of directors functions well, capital structure is efficient, incentives are aligned and investors value the firm appropriately. It is not clear in such a case what value private equity would add. But for companies that are underachieving or that have neglected all non-core parts of the business, or where the management is not delivering or governance is ineffective, private equity can provide rapid and fundamental change. The focus on value creation and the buy-to-sell approach can produce some spectacular returns for investors.

Concluding comments

Are those that work in private equity the new kings of capitalism? Some are certainly paid royally, although success is far from guaranteed. History is littered with unsuccessful one-fund wonders or previously successful firms that have lost their way. It is worth remembering that the riches do not just fall from heaven. The successful private equity firms employ some of the best talent around. Private equity provides a new model in the approach to governance and value creation which is certainly shaking up the thinking of all companies, few of which can feel immune to the reach of private equity. It is not quite a revolution, but it certainly is a challenge to the throne.

Tim Jenkinson

[1] This article is based on the podcast, 'Private Equity—New Kings of Capitalism?', by Tim Jenkinson, available from iTunes.