

# Going Private

Another private equity boom has passed, but the underlying need for the industry has not

BY VANESSA SUMO

In the mid-1980s, Meineke Discount Muffler had a problem. Automakers began fitting their cars with stainless-steel mufflers with life spans of 12 years. Until then, cars had been fitted with cold-rolled steel mufflers, which rusted after three years. This innovation was worrying for the Charlotte, N.C.-based company because a huge chunk of its business, about 65 percent in 1995, depended on short-lived mufflers.

Meineke managers were determined to find new ways to grow, but its parent company, an Australian multinational, wasn't too interested in investing in new plans. "They were very forthright about it," says Kenneth Walker, Meineke's president and chief executive. Meineke's role in the parent company's portfolio was mainly to generate cash, which the parent wanted to spend in other ways.

Meineke executives longed to be independent, a wish that was fulfilled in August 2003 when two private equity firms, Carousel Capital, located just down the street from the Meineke headquarters, and The Halifax Group, which has offices in Washington, D.C.; Dallas, Texas; and Raleigh, N.C., helped management buy Meineke from its parent company for \$68.5 million. Meineke changed its name to Meineke Car Care Center and was transformed into an independent company with a more diverse service offering, significantly improved marketing, and increased sales and profits. Carousel and Halifax assisted Meineke to get to that point in more ways than just injecting capital. Less than two years after buying Meineke, Carousel and Halifax sold their investment and another private equity firm stepped in.

Hundreds of deals involving private equity firms take place in the country every year. For more than 25 years, the private equity industry has been an important source of funds for a number of groups: entrepreneurs starting a business; families wishing to sell the business after the death or retirement of a founder; firms with strong growth prospects but in need of capital; companies in financial distress; and publicly listed companies seeking to go private. Private equity managers typically restructure the companies they buy and sell them later, keeping a part of the profits and giving the rest to investors.

Often, the deals take place with little publicity. Others are more high-profile, like the infamous takeover of RJR Nabisco in 1988 by Kohlberg Kravis Roberts & Co., one of the world's largest private equity firms. That deal inspired a book and a movie, *Barbarians at the Gate: The Fall of RJR Nabisco*, a title that suggests the kind of reputation which private equity firms had then and have even today.

Private equity has burst into the limelight again in recent years, primarily because of the large amounts of capital that some groups have been able to raise, as well as the size of the deals that have been made. In the 1980s, a \$200 million to





\$300 million fund would have been considered large. But today, that's just a fraction of the \$21.7 billion fund that Blackstone, another large private equity firm, raised in 2007.

The large influx of money from various investors, favorable credit conditions, and the willingness to form "club deals" allowed private equity firms to splurge on buyouts of some big-name companies. Chrysler, Hilton Hotels, and Hertz are just a few names. In the United States, the number of private equity-backed mergers and acquisitions (M&As) with values topping \$1 billion jumped from eight in 2002 to 102 in 2007, according to Thomson Financial.

But private equity is not just about the deals and the firms that make the splashy headlines. About nine out of 10 private equity-backed M&A deals worldwide were less than \$1 billion in the last three years, and seven out of 10 were under \$250 million.

Critics are skeptical whether private equity firms leave companies better off in the long run. They cite the quick flips, the sometimes ruthless, cost-cutting way private equity firms go about getting results, and the seemingly nonchalant way they spend money. The current turmoil in the credit markets, which will likely be

painful for private equity firms in terms of their ability to finance deals and the returns that they can expect, has prompted questions on whether this is the end of private equity.

That seems doubtful as past waves have shown. The private equity market tends to be cyclical. Moreover, most academic studies suggest that private equity firms do enhance the performance of the companies they purchase. The new owners, refining techniques developed over many deals, introduce strategies to make their companies more efficient. If so, then why is this industry so controversial? Part of the problem is the veil of secrecy that surrounds it. "This is still in many respect[s] a very mysterious business," said Harvard Business School's Josh Lerner at a private equity conference organized last fall by the think tank American Enterprise Institute (AEI). "There is a lot which is not really understood about it, and a lot of what seems to be understood is absolutely wrong."

#### **What is Private Equity?**

The private equity market is one way through which companies can obtain funds. Investors provide capital in exchange for ownership shares in companies that are not traded in

public markets, hence the name "private equity." But instead of investing directly in private companies, investors or the "limited partners" — typically big groups like public and corporate pension funds, financial institutions, college endowments, and sovereign wealth funds or very wealthy individuals — place their money in the hands of a team of professionals, or the "general partners." The general partners then select and manage a portfolio of companies on their behalf.

Private equity investing took off in the early 1980s thanks in part to the widespread adoption of this limited partnership arrangement. The other big boost came in 1978 from a ruling that putting money in seemingly risky private equity funds did not violate the Employee Retirement Income Security Act's (ERISA) "prudent man" requirement for investing private pension funds, as long as these investments were part of a larger pool. As a result, venture capital partnerships — the predominant private equity activity at that time — raised \$50 million in the first six months of 1979 from pension plans governed by ERISA, up from less than \$5 million a year between 1976 and 1978.

During the life of the partnership, usually about 10 to 12 years, the investors' money is tied up and they have little control over how it is managed. It might seem that investors would be better off without an intermediary. However, this would involve identifying and monitoring each of their investments. Effective private equity investing requires considerable skill in choosing and structuring investments as well as in providing business advice to acquired companies, expertise that firms presumably have gained through participating in a large number of deals. Thus, working through a private equity firm can be better than investing directly provided the limited and general partners' interests and incentives are well-aligned.

The compensation structure provides this control — as well as a lucrative way to reward general partners for good performance. When



a private equity firm sells a portfolio company, the firm returns the investors' capital and whatever remains is split between the general and limited partners. Investors typically take 80 percent of the profit, and the private equity firm gets 20 percent or what the industry calls the firm's "carried interest." The bigger the profit, the larger the firm's share of the pie, which is a powerful incentive to invest well. Limited partners also pay management fees equal to about 2 percent of the amount of capital they commit to a fund. But these fees are not based on performance and are intended to cover basic expenses.

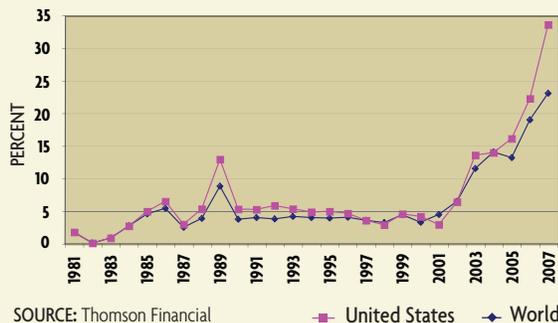
Reputation is also a valuable incentive. Private equity managers are eager to establish a good record because that determines their ability to raise more funds from investors and lenders in the future. Partnerships have a finite lifetime, and if a private equity firm earned a low return on its last fund, investors would seek other places to put their money.

From the portfolio companies' perspective, private equity can be a good alternative, especially if they are unable to raise capital from other sources such as banks or the public market. For instance, firms with high-growth prospects that are young and untested might benefit from venture capital, which is a type of private equity investment. America's venture capitalists have financed well-known companies like Google, Apple Computer, and Intel.

Smaller family firms may have opportunities to grow but are resource-constrained. The founder may have to put in more of his own money, but he can only do that for so long. "Their family and friends network is only so big and so they need to go to an outsider," says Fred Russell, managing director and CEO of Virginia Capital Partners, a small private equity firm in Richmond. Also, as the founder of the firm ages, he may want to retire and sell the business.

### Heady Growth

The value of private equity deals surged to about a third of all merger and acquisition deals in 2007. However, analysts say that private equity activity slowed in the last few months of that year.



The issue of succession applies to middle-market family firms and closely held private companies as well, which are typically bigger, well-established companies with stable cash flows. The company may be sold to the heirs of the founding family or a new management team in partnership with a private equity firm that organizes the funds for the sale. Middle-market firms may also be looking for capital to finance an expansion or acquisition. Depending on their size, these firms do have access to debt markets, but that may not be sufficient to meet their financing needs. And because they may have no desire to go public, private equity can be a good option.

But perhaps the most familiar private equity transactions today are buyouts of public companies. Many people have probably heard of a leveraged buyout, which is a common way of taking over a big public company using a substantial amount of debt. Public companies go private so they can have a freer hand in making adjustments that will benefit the company, without having to constantly worry about short-run fluctuations in their stock prices, the costs of compliance imposed on public companies by the Sarbanes-Oxley Act, and various pressure groups. Of course, CEOs will still have a boss: the private equity firm.

### Inside a Deal

Private equity firms buy shares in private companies that they hope to

sell later at a higher price. Companies typically go through a process of what Harvard's Lerner calls "intensive therapy." This process can be painful as private equity firms work to weed out inefficiencies. But the hope is that companies will emerge healthier, more profitable, and more valuable. How do they do this?

A report by consulting firm McKinsey & Company finds that in the best-performing deals, partners devoted more than half their time to a portfolio company during the first 100 days and met with top executives almost every day. Carousel Capital likewise thinks this is a key factor in determining the success of an investment. "We're a big believer that investing relatively close to home is a good practice, because it promotes so much interaction between the investors and the management team," says Brian Bailey, one of Carousel's managing partners.

Carousel prefers to invest in the Southeast so that the partners can easily get to their companies and spend more time with management when needed. Meineke's Walker talked with his primary contacts at both firms about once a month, if not once a week. Although few private equity firms are located just a few blocks from one of their portfolio companies, he could sometimes meet up with a Carousel partner for lunch and talk business. "It was an informal way to stay connected with one of the partners," says Walker.

Private equity firms are demanding bosses. "If you talk to managers who work with private equity partners on their board ... 'anxious vigilance' can sometimes describe their world," said economist Karen Wruck of Ohio State University at the AEI conference. General partners "vigorously exercise their governance rights," said Wruck. Running the business becomes a much more intense process, where private equity partners ask tough questions and make managers understand how



their decisions affect the value of the company. It's not so much that private equity firms always know how to run a specific business. Their knack is in finding the right people and organizing the company in such a way that they let managers use their expertise but hold them closely accountable for the results. Private equity firms can get very good at employing the same principles over and over again — applied many times to different deals and companies.

Changing the capital structure of a company through a leveraged buyout is another way to align the incentives of management and shareholders, but private equity firms often get much flak for using a lot of leverage. Borrowing to finance a buyout allows private equity firms to purchase companies with only a small amount of equity capital, and shareholders to receive very high returns. Say, for example, a private equity firm buys a company for \$100 million, using \$30 million of its own equity capital and \$70 million in borrowed funds. If the private equity firm later sells it for \$130 million, then, after repaying the debt, the investors actually double their money even though the company's value rose by only 30 percent. The gains flow mostly to equity holders because debt holders receive only a fixed rate of return. Critics say, however, that piling on debt makes a company more vulnerable to going bust and therefore poses a risk to the economy.

But leveraging can be a powerful tool in changing the way managers behave. Economist Michael Jensen of the Harvard Business School noted almost two decades ago that a central weakness of a public company is the inherent conflict between owners and managers of a firm over the control and use of corporate resources. In particular, managers of public companies may be hesitant to distribute the extra cash that is left over (after all profitable investments have been funded) to shareholders in the form of dividends. Managers want to hold on to this extra cash

because it makes them less dependent on the capital markets.

This may, however, lead to a temptation to invest in wasteful projects if they no longer need to convince providers of capital each time of the soundness of their investment plans. Borrowing, therefore, can impose discipline on company managers. Since interest is paid out of a company's cash flows, paying off debt is in effect a substitute for paying dividends. Debt can improve the company's performance because managers must make sure that there is enough cash to meet interest payments and because they are dissuaded from squandering company funds.

A leveraged buyout also puts equity in the hands of a smaller group of investors, which mitigates the problem of monitoring managers when there are many dispersed shareholders. Moreover, buyouts usually dictate that managers invest their own money in a substantial stake in the company, so they're given a bigger chance to participate in the success (or the failure) of the company. CEOs of portfolio companies tend to own a larger share of the company than their counterparts at public corporations, and this can be a powerful incentive.

Leveraging is an important part of the private equity firms' tool box, but it is no longer a strategy that is only available to private equity firms. So, even as firms apply financial and governance techniques, they also focus specifically on improving their portfolio companies' operations, by building industry expertise and bringing in operations specialists and consulting groups to help them identify points for improvement. Some of these measures include reducing costs, for which private equity firms are sometimes heavily criticized. But even as they cut and tighten, buyout shops today also look for opportunities to expand the reach of their companies' products in this country or abroad.

While it is possible for public companies to employ these same techniques without having to go private, it may be difficult to do in

## Private Equity's Impact on Jobs

There are other ways to measure the private equity industry's contributions apart from financial returns. A 2007 *Journal of Corporate Finance* paper surveys U.S., U.K., and other country studies on the real effects of buyouts. The summary finding is that buyouts "enhance performance and have a salient effect on work practices" of their portfolio companies. For instance, plant productivity increased substantially after a buyout. However, much media attention has focused on employment numbers. Critics, in particular, have often accused private equity firms of enriching themselves while slashing jobs in the process.

That private equity destroys jobs is not completely untrue. "It's not that it's an inaccurate claim, but when you fill out the whole picture, the story is much more mixed," says University of Chicago Graduate School of Business economist Steven Davis, who co-authored a large-scale study of the employment impact of buyouts on U.S. establishments. "I don't think the story fits with the narrative that the critics have put forth, nor does it really fit the sometimes glowing testimonials from the private equity community itself," says Davis in an interview.

The study, published in the January 2008 World Economic Forum report, follows target businesses before and after the buyout transaction, and then compares them with other establishments with no ties to private equity. When broken down in terms of job creation and destruction, target establishments are cutting jobs at a faster rate than comparable businesses, but target businesses create jobs at a similar pace. This suggests that private equity firms start out with some "housecleaning" of businesses which seem to be already in distress even before the buyout, as the study finds.

But companies also expand their businesses, and thus employment, when they open new manufacturing plants, retail locations, and other facilities. Thus, to complete the picture, the authors look at jobs create by private equity-backed companies at these newly opened establishments. Private equity emerges the winner: They find that target firms create jobs at a much faster rate than firms with no ties to private equity. Overall, it appears that job losses are partly offset by job gains from this expansion.

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practice, particularly with respect to governance. In portfolio companies, CEOs effectively have a boss. In a public corporation, by contrast, CEOs typically don't have one. Jensen, who also spoke at the AEI conference, said that the board of directors of a public corporation generally see themselves as employees of the CEO. This situation changes only in the event of a crisis, but by that time, too much inefficiency has already set in. (Public-to-private transactions account for about a quarter of all buyouts worldwide in terms of dollar value, according to a recent World Economic Forum report. Most buyouts are acquisitions of private firms and corporate divisions.)

In the end, whether the hard work has paid off partly depends on the private equity firms' ability to "exit" an investment well; that is, to find the right buyer. An exit route can be arranged through an initial public offering (IPO) of the company, accomplished by selling shares in the public market or by selling the business to another company or private equity firm.

In Meineke's case, the partners had a five-year plan that they achieved in less than two years, and everybody around the table agreed that it was time to move on. "Companies do get to a certain point in their life cycle where they would perhaps benefit from another owner," says Bailey. Carousel and Halifax were bought out by Allied Capital, a private equity firm based in Washington, D.C., together with Meineke's management. Carousel and Halifax say they earned more than their typical annualized target return of 25 percent. "They were the right partners at the right time," Walker says.

### Measuring Performance

If you ask Walker, he'll say that private equity firms do create value. His big idea was that the company could grow quickly and profitably by buying other franchise automotive brands while taking advantage of the company's

back-end resources, which include the accounting, legal, and financial management departments. He was proven correct. "It was private equity that allowed us to do that," says Walker. "It just allowed us to be a more efficient company."

However, others are more doubtful about the merits of private equity. The quick flip is one tactic that doesn't come across favorably, with many asking whether overleveraged companies have been sold too rapidly in the public market. For instance, the private equity groups that bought car rental company Hertz in 2005 announced an IPO in just less than a year, which prompted *BusinessWeek* to call that move "rent-a-company." A 2006 NBER paper by Lerner and Jerry Cao of Boston College finds some evidence that leveraged buyouts which went public after less than a year performed much more poorly than companies held longer. Such a strategy would then seem futile since buyout groups typically retain large ownership stakes after the IPO and failure is too costly for their reputation.

But Lerner and Cao also find, overall, leveraged buyouts that later offered shares to the public through an IPO "consistently outperform other IPOs and the stock market as a whole." Moreover, they find no evidence that the returns of these "reverse" leveraged buyouts deteriorated over time. This suggests that private equity firms make their portfolio companies more valuable, even long after an IPO.

Another way to measure performance is by comparing the returns of a private equity fund to one that invests in a stock market index such as the S&P 500. In other words, which would do a better job of generating higher returns — a private or a public company? A well-cited 2005 Journal of Finance study by University of Chicago Graduate School of Business economist Steven Kaplan and Antoinette Schoar, an economist at the Massachusetts Institute of Technology, finds that the returns to private equity funds — *gross of fees*

paid to the general partners — beat the returns on investing in the S&P 500 (the analysis includes venture capital and buyout funds). Other studies come to similar findings.

However, Kaplan and Schoar's study finds that the same returns to private equity funds — *net of fees* — were roughly equal to the returns on the S&P 500. So, while their findings suggest that private equity firms create value at the company level, investors don't seem to do better than if they just put their money in a market index fund. It would then seem bizarre that investors pour so much money in this asset class given the poor returns.

There may be other reasons why investors put their money in private equity funds. Investors might value the option of participating in a future fund if participating in the first one gives them access to the next. Investors know that in this business, a firm can get better at what they do over time. Certain investors like big investment banks may also value investing in private equity funds for the relationship that comes along with it, because they value the possibility that private equity firms will call upon their consultation or underwriting services. Or, it could be that investors have a hard time comparing funds' returns to that of the market index.

But the best-performing funds within this larger group do better than the market index even after fees. There seems to be persistence in fund performance as well; that is, a good private equity firm can consistently generate good returns. This persistence is stronger than in other fund types such as hedge funds and mutual funds.

### Feast, Famine, and the Future

As credit markets became more cautious over the past several months, many predicted a substantial slowdown and even the demise of what they perceived was an overheated private equity market. But the boom-and-bust nature of the industry is nothing new. "This is a story we have



seen many times before,” said Lerner.

Money from investors flows into private equity when returns are perceived to be higher relative to other types of investment. Together with favorable credit conditions, which are important to private equity because the deals typically involve leveraging, private equity firms can raise large funds for their acquisitions. But more capital available means more competition, which bids up the prices of companies they buy. Moreover, when the industry as a whole is doing well, money also flows to inexperienced groups who enter the market in the hopes of replicating the success of the industry’s best performers. Hence, as the supply of capital goes up, returns go down and investors pull out. Poor performers leave the market, competition eases, returns go up, and the cycle starts all over again.

The buyout boom of the late 1980s, culminating in Kohlberg Kravis Robert & Co.’s takeover of RJR Nabisco, is in many ways comparable to the heady growth in buyouts in the last few years. Both episodes were marked by large amounts of capital, record-breaking deals, intense public scrutiny, and the use of debt securities that fueled aggressive deal-making (the junk bonds of the 1980s and the collateralized loan obligations of recent years).

As in the earlier buyout wave, deal volumes and returns on private equity investment will likely drop as the

current cycle turns. The difference, however, is that the companies’ capital structures are actually much safer today, said Kaplan, who also spoke at the AEI conference. Even with the firms’ aggressive use of debt, companies’ debt levels are lower and there is more of a cushion to make repayments. Thus, in the event of a recession, portfolio companies will probably not experience the large number of defaults that was seen in the early 1990s.

But even those who believe in the merits of private equity worry that some of the firms’ practices may be weakening the very attributes that have made them effective at what they do. For instance, because the amount of capital committed by investors has increased tremendously in recent years, the management fees collected by the firm as a percentage of this capital has likewise soared. Lerner cited a study that shows partners’ pay from “carried interest,” the performance motivator, is actually a relatively small slice of their overall compensation and that much of the income comes from fees. He thinks that this is a concern because it might lead to pressure for firms “to just do the safe thing, rather than doing the right thing.”

There are also worries about private equity firms themselves going public — as Blackstone famously did in 2007 — because it could undermine the incentive structure that has been built into the limited partnership

arrangement. Private equity firms are motivated to make deals work because their reputations are on the line. Their partnerships with investors have a fixed lifetime, so if they want to raise another fund, they must show investors that their past funds have performed well. Thus, replacing the funding provided by a partnership with permanent capital from issuing public stocks removes this important motivator.

As this relatively young industry grows in size and influence, it is perhaps inevitable that there are increasing pressures for more regulation and transparency. Some are also calling for private equity partners to pay taxes on the carried interest based on the income tax rate, rather than the lower tax rate on capital gains.

But those who think that private equity will fall under the heavy weight of criticism and its perceived excesses might be disappointed. The industry has been remarkably successful and it generally has a good story to tell. Its influence extends even beyond the firms that it operates. “If you have a competitor who has private equity as a significant owner and they are making huge improvements, you had better make similar improvements or you will not be competitive,” said Wruck. The message is clear: Companies that are not backed by private equity firms will be forced to shape up. Otherwise, they may soon find themselves competing against one that is. **RF**

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