

## Fact & Fiction

Provided by the Private Equity Council

### **Fiction: Private equity funds and hedge funds are essentially the same.**

**Fact:** Private equity often is confused with hedge funds. But the two forms of investment differ in some important ways. Private equity funds invest in companies with the intent of owning and operating them for several years or more.

The goal is to grow them quickly and turn them around, or otherwise strengthen their performance. Private equity firms typically create value by improving the operations, governance, capital structure, and strategic position of the companies in which they invest.

In contrast, hedge funds are a loosely-defined category of investment pools that, like a retail mutual fund, principally invest in publicly traded securities, currencies or commodities. While most mutual funds typically own “long” positions in securities, (that is, they own the security with the hope it will rise in value), a hedge fund may take “short” positions (betting that a company’s stock price will fall), and engage in many more complex trading strategies, including futures trading, swaps and sophisticated derivative contracts.

### **Fiction: Investors in private equity funds all are wealthy individuals**

**Fact:** Public pension funds, university endowments and leading foundations represent the single largest group of investors in PE and collectively accounted for one-third of all capital allocated to private equity in 2006. The 20 largest public pension funds for which data is available (the California Public Employees Retirement System, the California State Teachers Retirement System, the New York State Common Retirement Fund, the Florida State Board of Administration, among others) have some \$111 billion invested in private equity, delivering strong investment returns for their 10.5 million beneficiaries. These public and private pension funds, foundations and university endowments have chalked up returns from private equity investments that far exceed those available from the stock market. Between 1991 and 2006, private equity firms worldwide distributed more than \$430 billion profits to these and other investors. These returns translate into stronger public employee pension programs, more funds for college financial aid and scholarships and more funds for research and other causes supported by charitable foundations.

### **Fiction: Private equity firms have no commitment to growing companies.**

**Fact:** Quite the contrary. The entire private equity business model is predicated on investing in and strengthening acquired companies so they are worth more when they are sold to another buyer or to the public markets. To earn a profit on the transaction, private equity firms must make the companies more valuable by increasing earnings and cash flow. If the private equity firm strips a company bare, no one would want to buy it, much less pay a premium over the original purchase price. It would be as if someone bought a house and then proceeded to tear out the kitchen, the bathrooms, the plumbing and the wiring and then tried to sell the house for a profit. In fact, the buyer would have remodeled bathrooms, fixed up the kitchen, updated the plumbing and electrical systems – and then sold the house for a profit. This is precisely what private equity firms seek to do. They own and operate acquired firms for several years and create value by improving operations, governance, capital structure and the strategic direction of the companies in which they invest.

### **Fiction: Private equity firms are “quick flip” artists that buy companies and then sell them to make a fast buck.**

**Fact:** The “quick flip” claim is a canard. Private equity firms typically are long term investors, not quick flippers, because it takes time to strengthen companies so they are worth more to future buyers. PE funds own the companies they acquire for an average of three to five years (although there are occasions where some companies are sold sooner).

### **Fiction: Private equity firms weaken companies by stripping them of assets.**

**Fact:** The notion that private equity firms strip valuable assets out of the firms they acquire defies common sense. It seldom makes sense for a private equity firm to buy a company with the intention of selling off its parts. This strategy is inherently risky because it is not easy to pull apart operating businesses. In addition,

there is always the risk that the prices realized will not be enough to compensate for the amount paid – if anyone is willing to buy the parts in the first place. To the extent a private equity firm does find that it makes economic sense to sell parts of a company after it is acquired, it is likely because the conglomeration of assets did not make sense in the first place. Public companies do this all the time (this is how the large conglomerates were dissolved in the early 1980s) and some of the great companies of the modern era are the result of such “spin offs” (Capital One Financial is one example).

There is another practical reason that so-called “asset stripping” is unwise. Private equity companies exit their investments in two ways: through an IPO or a sale to strategic investors. In an IPO, the public equity market places a value on the improvements made by the private equity owner. If the private equity firm has stripped assets and turned the company into a shell, the price will be steeply discounted. In a sale to strategic investors, the buyers are highly sophisticated businesses or institutions that understand how to read balance sheets. In both cases, given the many investment options available, investors would not put their dollars into companies that have been so weakened as to undermine their ability to profit from their investment.

**Fiction: Private equity buyouts typically result in layoffs.**

**Fact:** While data on private equity investment’s impact on employment in the United States is anecdotal, research in Europe suggests that PE investments do indeed result in long term job growth. A study by the international management consulting firm A.T. Kearney found that PE firms generate employment, on average, at a much faster pace than comparable, traditionally financed firms. Research by the British Venture Capital Association on both venture and private equity portfolio companies found that during the last five years, businesses backed by private equity increased employment an average of nine percent per year compared to one to two percent for public companies. The Financial Times studied the 30 largest European private equity transactions in 2003-04 and reported that “overall, jobs were more likely to have been gained than lost as a result of private equity backed buys.” A recent study by the Munich Technical University for the European Private Equity and Venture Capital Association (EVCA) found that between 2000 and 2004, European businesses acquired in buyout deals recorded a net increase of 420,000 jobs.

**Fiction:** Private equity firms load up companies they buy with massive amounts of debt.

**Fact:** Private equity firms invest their own equity side-by-side with other investors, thus sharing in the risks and giving them very real incentives to make prudent investments, not highly speculative ones. To that end, PE firms engage in extensive due diligence – sometimes for a year or longer – to determine the optimal capital structure for a potential acquisition. They analyze not only the company’s performance, but the competition, the sector, growth prospects, management capabilities, and how companies will perform under varying economic assumptions.

Because they have their own equity at risk, and because they cannot profit on their investments until they pay their limited partner investors the first eight to 10 percent of the profits from each investment (the “hurdle rate”), it is important for them to manage their investments with a keen understanding of risks and appropriate use of leverage. Furthermore, major commercial banks provide the overwhelming portion of the loans that finance buyouts and they impose their own underwriting standards that operate as a further check on private equity firms using excessive debt in a given transaction.

It is worth noting that debt levels today are far lower than in the early days of leveraged buy-outs, or LBOs. In the 1980s, financing was often 90 percent or more debt and 10 percent or less equity. Over the last decade, equity levels in private equity transactions are often between 30 and 40 percent. Since 2002, with interest rates consistently low, debt is cheaper, and debt levels have ranged from 60 percent to 66 percent, although there have been more recent deals with higher debt levels due to the unusually low interest rate environment of the past few years.

**Fiction: Private equity firms have no incentive to improve the businesses they operate.**

**Fact:** The goal of a private equity firm is to sell a company at a premium to the original purchase price – that’s strong incentive in and of itself. In the case of reverse LBOs (when a company is returned to the public markets), the private equity firms often remain a majority or large minority shareholder in the business. In other words, destroying the business for short term gain would take money out of its own pocket by undermining the value of its own investment, or make the investment less attractive to a buyer, thus eroding its profit at sale. Either way, undermining a company’s strength is not a path to success in private equity investing. PE firms have only one incentive: take those actions which increase long term value – anything

else means they are short-changing themselves, not just their limited partners. Finally, the limited partners who invest in PE funds are among the savviest investors in the world. They would not continue to invest their money in private equity funds that that destroy value rather than create it.

**Fiction: Private equity firms do nothing to improve the businesses they buy and operate; it's all about financial legerdemain.**

**Fact:** At one time, a strategy of simply adding more debt to an “under-leveraged” balance sheet might have allowed private equity firms to recognize substantial gains with only modest business performance improvements. This approach no longer works. To succeed today, a private equity firm needs to bring much more to the table than financial creativity. The PE firm must add new capabilities to the company it buys (by adding new products), increase competitiveness (by reducing waste and improving operations) and grow revenues (by entering new markets or finding new customers) to make any money for itself or its investors. And it needs to develop, implement and successfully execute a compelling strategy to do so. Today, private equity firms deliver deep expertise in the sector in which the investment is being made. And they do it well. Harvard Business School Professor Josh Lerner found that between 1980 and 2002, the stock price of companies PE firms brought back to market after operating them for more than a year rose faster than both the overall stock index and the share price of firms in the same sector not backed by private equity. Clearly, the PE firms were creating significant value in the companies they operated.

**Fiction: If a few mega deals fail, the effect will ripple across the world, causing a severe crisis in global capital markets.**

**Fact:** In truth, this was likely a greater risk in the 1980s than today. Today's capital markets have become broader and deeper. Banks that loan money to fund today's private equity deals quickly syndicate, or sell off, large portions of their loans to investors around the world. If a loan is in trouble, the bank has spread the risk to scores, sometimes hundreds, of other creditors. It is very unlikely that any single bankruptcy, or even several major ones, would create a systemic risk to global markets. These lenders are closely regulated by the federal government. In fact, the Federal Reserve Board has disclosed that it is reviewing bank lending to fund private equity buy-outs to ensure that it is prudent and does not create systemic risks. The institutions and funds that buy a portion of the loan syndication themselves are highly diversified to reduce the risk that the loss in a single investment will be disruptive to their overall liquidity or survival. Finally, private equity firms have hundreds of millions of dollars of their own funds at risk and therefore have strong incentive to conduct rigorous due diligence on every acquisition to ensure the acquired company can operate even in a downturn.

**Fiction: Pension fund investments in private equity partnerships endanger the retirement security of tens of millions of Americans. If one of these deals fails, retirees will lose millions.**

**Fact:** Pension funds have strict limits on the amount of assets they can allocate to private equity and other alternative investments. In most cases, this allocation is under 10 percent. And when they do make these type of investments, they have positions in several funds that collectively might own 20 or more businesses. In short, the amount of assets invested is strictly controlled and the diversification of the portfolio means that a bankruptcy in a single portfolio would have virtually no impact on a pensioner's benefits.

**Fiction: Private equity firms operate in a secretive and opaque world. No one really knows what they're up to.**

**Fact:** There is substantial disclosure involving private equity investments; arguably, investors know more about their PE investments than average investors know about their mutual fund or stock market holdings. PE firms engage in extensive, thorough disclosure to their limited partners, including detailed performance and return information, as well as substantial detail about each company they own and operate. Further, the majority of PE portfolio companies issue public debt. As a result, these companies are obligated to file the same 10k report as public companies, with the same level of detail, all readily available on the SEC's website.

**Fiction: When public companies go private, the transactions are riddled with conflicts. As a result, shareholders rarely get a fair price when the company is sold.**

**Fact:** When a public company is a candidate for going private, the process is similar to that involving any other merger. If the management is approached by a private equity firm, management is legally obligated to report this to the Board of Directors, which in turn is required to set up a special committee made up only of

independent directors. Once the company is seriously considering a buyout, all normal SEC disclosure laws are triggered. That means management is required to file proxy statements and obtain fairness opinions, which must be reviewed by the SEC. As in all other acquisitions, the Board of Directors has a fiduciary obligation to act in shareholders' interest. Finally, institutional shareholders have demonstrated in several high-profile private equity bids that they hold tremendous power and perform a watchdog function to prevent shareholders from being denied a fair price. It is now typical in most PE transactions for the company to insist on provisions allowing the board to shop the private equity firm's offer to others to ensure that the bid on the table is the best available option.