

## Frequently Asked Questions

Provided by the Private Equity Council

*"Here's what private equity firms have figured out how to do: attract and keep the world's best managers, focus them extraordinarily well, provide strong incentives, free them from distractions, give them all the help they can use, and let them do what they can do. No wonder these companies tend to be outstanding performers."*

**Fortune, November 27, 2006.**

### Introduction

Private equity has been much in the news lately. According to Thomson Financial, private equity transactions in the United States last year totaled \$406 billion.

Once considered an esoteric form of "financial engineering," PE in recent years has become an important tool for driving growth and improving performance at hundreds of companies across the country and around the world.

In addition to transforming the companies they acquire, private equity firms have delivered superior returns to scores of public and private pension funds, university endowments, charitable foundations and other investors.

### PE delivered \$430 billion to pension funds and other investors

Between 1991 and 2006, private equity firms worldwide created more than \$430 billion in profits for their investors, 40 percent of which are public and private pension funds and foundations, according to the research firm Private Equity Intelligence.

In a nutshell, PE is an ownership structure that enables a private equity firm and its investors to acquire companies – either public or private – that often are undervalued or underperforming, or are "orphaned" outside the core business of a larger conglomerate.

The PE firm invests time, energy, talent and capital to improve the company's performance and its prospects. After several years, usually between three and five, the PE firm sells the company, hopefully at a premium to the purchase price. A full 80 percent of the profits go to the limited partner investors, including many public and private pension funds, university endowments and charitable foundations.

For the past twenty years, private equity activity has ebbed and flowed depending on underlying economic and capital market conditions.

### Three factors stimulate PE growth

Three major factors have converged to stimulate the record growth in private equity activity.

First, the shares of many public companies have been relatively inexpensive compared to the value of their assets and revenue. Second, capital available to private equity firms has increased dramatically as major investors such as pension funds, mindful of the superior returns available, allocate more of their portfolios to private equity. Third, the global market for the debt that is borrowed to help finance the acquisitions has grown, permitting more borrowing at better rates. As these and other market forces adjust, the pace of private equity transactions will be affected and will likely decline from current levels.

The following Q&A seeks to address some of the most frequently asked questions about private equity.

### Q: What is private equity?

**A:** The term "private equity" refers to a range of investments that are not freely tradable on public stock markets. Private equity firms raise money for two types of funds: venture capital funds and buyout/growth funds. Most of the recent attention on private equity involves the buyout/growth capital segment of the market which has grown considerably in recent years.

At its core, private equity is simple: PE firms establish funds that raise capital from investors – who are referred to as limited partners, or LPs. The private equity firms – known as general partners or GPs – invest this capital on behalf of their investors, along with funds borrowed from banks and other lenders. The general partners buy companies that they believe could achieve significantly greater growth and profitability with the right infusion of talent and capital. Their approach is to put in place strategies and management teams to improve the company's performance.

Private equity GPs typically hold companies for three to five years, and then sell them, hoping to realize a gain on the sale as a result of the increased value they have created during their period of ownership. The size of the capital gain directly relates to the increase in value the PE firm has created. Generally, 80 percent of the profits are distributed to limited partner investors.

**Q: Who benefits from private equity?**

**A:** The big winners are public pension funds, university endowments, and leading foundations. Together, these funds represent the single largest group of investors in PE and collectively accounted for one-third of all capital allocated to private equity in 2006. In fact, the 20 largest public pension funds for which data is available (including the California Public Employees Retirement System, the California State Teachers Retirement System, the New York State Common Retirement Fund, and the Florida State Board of Administration) have some \$111 billion invested in private equity, delivering strong investment returns to their 10.5 million beneficiaries.

Add in corporate and some union pension plans and it becomes clear that private equity has gone to work on behalf of tens of millions of Americans. Of course, the private equity industry's executives also benefit from the returns generated by these investments. However, the perception that private equity is mainly about a handful of New York financiers doing very well at everyone else's expense is demonstrably misleading.

**Q: Do private equity firms only acquire publicly-traded companies?**

**A:** Private equity transactions take many forms. Private equity may involve the acquisition of a private company with the intent of providing its founders the capital necessary to take its performance to the next level. It may involve the acquisition of a division of a large company, with the purpose of offering the newly-independent business the management focus and resources needed to achieve a new mission. Or it may involve a "public to private" transaction in an effort to undertake improvements that would be difficult to achieve given the short-term earnings focus of the public markets.

Most recently, public-to-private transactions have gained the most attention. These transactions offer a way of increasing the value of businesses by temporarily transferring ownership from millions of public shareholders to a much smaller number of private owners. Without the pressures from outside shareholders looking for short-term gains, owners and managers can focus in a laser-like way on what is required to improve the medium to long-term performance of the company. This structure makes it far easier to align the interests of owners with those of managers, who also have a direct stake in the success of the company.

**Q: What's the difference between private equity funds and hedge funds?**

**A:** Private equity seeks to create value over the long-term; hedge funds typically have a much shorter time horizon. Private equity funds typically buy and own whole companies and help them realize earnings growth over time. Private equity investors succeed only when the companies they own succeed. PE funds typically own companies in their portfolios three to five years, though they sometimes exit the investment sooner. Hedge funds are pools of capital that usually invest in stocks, bonds, or commodities. Typically, they do not purchase a controlling interest in a company (although some are now doing so). Rather, they try to capitalize on short-term gains, using complicated trading strategies involving options and other derivative financial instruments. In some cases, hedge funds bet against the shares of companies they don't own, hoping to profit from a falling price. The typical holding period for a hedge fund investment is weeks or months, not years.

**Q: What's the difference between venture capital funds and buyout/growth funds?**

**A:** Venture capital funds focus on one end of the business lifecycle: they invest capital in start-up and young companies with little or no track record. Buyout/growth funds focus on another segment of the business cycle: they invest capital in more mature businesses that are underperforming or that have the potential to "outperform" with sufficient capital and/or operational improvements. They seek to own and operate these businesses, typically for several years, creating value by improving operations, governance, capital structure and the strategic direction of the companies in which they invest.

**Q: Why would you want to take a public company private?**

**A:** Over the last few decades, many experts, including leading CEOs and academics, have complained that the public markets create tremendous pressure on companies to generate steadily upward quarter to quarter growth. But it is well documented that decisions made to satisfy investors in the short term may not be in the best long-term interests of the business.

For example, faced with a major R&D investment that could depress earnings and the company's stock price, management might opt not to make the investment to keep the stock price higher. Similarly, a public company CEO might not pursue a strategic acquisition that made long-term sense if the short-term effect would be to dilute the earnings that large institutional investors use quarter-to-quarter to guide their stock buying and selling. In contrast, private equity firms focus on long-term performance.

**Q: How does private equity change the short-term mindset and enhance growth?**

**A:** As a backdrop, it is important to understand one overarching truth about private equity: the entire investment hinges on improving the business and increasing its value. If the private equity firm fails to do that, it loses money, its investors lose money, and its ability to raise future funds is undermined. The essence of private equity is the alignment of the interests and incentives of management with that of the owners. In a public company, the owners – shareholders – are largely separate from the management of a company. Private equity eliminates this disconnect.

The owners often include the management (PE firms usually require management to invest their own money into the company so they have a vested interest in its success) this provides a sharper focus on how capital is allocated across the business – without the constant pressure of delivering quarterly results to public shareholders. Everyone has a single objective: grow the company's value. Thus, they can make business decisions solely focused on that goal, rather than satisfying external constituencies, such as analysts, traders, stock brokers, and the media.

**Q: What other steps do PE firms take to improve company performance?**

**A:** To succeed today, a PE firm needs to bring much more to the table than financial creativity. It must be an active owner. 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 business strategy.

The best private equity firms today deliver deep expertise in the sector in which the investment is being made; a performance culture that rewards entrepreneurialism and results; managerial and functional capabilities (IT, for example); and an ownership structure that allows even the toughest decisions to be made quickly.

**Q: You said PE firms add debt to the balance sheets of companies they own. Don't higher levels of debt create real risk that the company will go bankrupt?**

**A:** Higher levels of debt can create more risk. But debt at sound levels often helps focus management on the right goals: increasing revenue to meet all their obligations. Spending on wasteful practices such as corporate jets, lavish corporate headquarters, and other outlays that have little to do with improving the bottom line are difficult to justify. Rather, every action is predicated on the question: will it grow the business and overall value? In a sense, the mindset in a PE firm is more like the homeowner with a mortgage who makes sure they can meet their monthly mortgage payments before spending on non-essential, luxury items.

**Q: Why is debt involved if the ownership structure is referred to as private equity?**

**A:** Virtually every company, public or private, has a capital structure made up of equity (stock) and debt (bank loans, bonds, etc.). When a PE firm acquires a company, they arrange financing which is made up of equity they invest from their funds and loans from a variety of sources, mostly banks.

**Q: What makes private equity an attractive investment?**

**A:** Private equity has delivered superior returns to investors over the past two decades. Research by Professor Steven Kaplan, University of Chicago, has shown that over the last twenty years the top buyout funds (typically those raised by PEC members) usually generate returns more than triple the overall returns of the US stock market. Another study found that during the past 25 years, top-quartile PE funds generated

annual returns of nearly 39 percent, compared to 12.1 percent for the S&P 500 and 12.3 percent for the NASDAQ. Between 1991 and 2006, private equity firms worldwide created more than \$430 billion in profits for their investors, according to market research firm Private Equity Intelligence.

**Q: Is there any evidence that PE firms improve businesses while in private ownership?**

**A:** Harvard Business School Professor Josh Lerner found that between 1980-2002, the stock price of the firms PE companies brought back to the public equity 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.

**Q: Beyond benefits to the corporate sector and large institutions, does private equity benefit the broader economy and society?**

**A:** Superior returns from private equity investments strengthen pension funds that provide benefits for millions of workers. According to Private Equity Intelligence, private equity firms worldwide delivered net returns of \$430 billion to their limited partner investors in the period from 1991 to 2006. A corollary benefit from these exceptional returns is that dozens of states were able to avoid budget cuts or tax increases that would have been required to meet their legally mandated pension obligations to retirees who have devoted their careers to public service. More broadly, research shows that private equity investment results in long-term employment growth and enhances the economic viability of a business to the benefit of all stakeholders. Research by A.T. Kearney found that PE firms have created jobs across the world, and that PE-financed firms generate employment, on average, at a much faster pace than comparable, traditionally financed firms. A study by the British Venture Capital Association found that over the last five years businesses backed by private equity increased employment an average of nine percent per year compared with one to two percent for public companies. BVCA also reported that PE companies grew sales faster than public firms as well and that their investment and R&D outlays grew at an average annual rate of 21 percent. A separate study by the European Venture Capital Association found that between 2000 and 2004, employment in private equity-backed companies rose by 5.4 percent, almost eight times higher than the European Union average of 0.7 percent. Finally, 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.