Private equity

Monsters, Inc?

Private-equity firms may make the economy work better, but their bosses get too much cash

Jan 28th 2012 | from the print edition

THE public has never loved the way that private-equity titans make a buck—or billions. But now that Mitt Romney's career at Bain Capital, a buy-out firm, is fodder for his Republican rivals, it has become fashionable to demonise private equity as "vulture" capitalism and "worse than Wall Street". Do Mr Romney and his ilk deserve such opprobrium?

Two charges are generally made against private equity. The first is that it plunders companies and slashes jobs. The other, underscored this week when Mr Romney released his tax returns, is that private-equity executives are obscenely rich in part because they do not pay enough tax.

Private-equity firms claim to make money by taking over poorly managed companies, improving their performance and selling them on. Often that involves cutting jobs. At a time when American unemployment is stuck at a worryingly high level, this has made private-equity firms a target for anger from both Republicans and Democrats.

Yet the direct employment losses that result from private-equity deals are not as large as critics claim: on average employment declines by only 1% two years after a buy-out, once the jobs created at new facilities are counted. Such shifts in employment are part of the creative destruction that invigorates the economy, and if private equity hurries the process along, that is all to the good. The evidence suggests that it does. Private-equity buy-outs tend to increase productivity—by around 2%, on average, according to one academic study. If firms become more efficient, the economy works better. Resources will be reallocated where they can better be used.

Debt in, dividends out

Critics are on stronger ground when they complain that private-equity firms burdened companies with debt, took the cash out as dividends and sometimes drove them to the wall. Bankruptcy was not the intention nor, in the great majority of cases, was it the outcome. But as the price of debt fell, that pattern became increasingly common. From 2004 to 2011 private-equity firms piled more debt onto their companies so they could take out $188 billion in dividends to pay themselves. The deals got bigger and bigger. The largest ever, in 2007, was the $44 billion purchase of TXU, an electricity company. The market worries the company will go under.

But though the private-equity people may have walked off with the loot, America’s tax code was partly to blame, because it encourages this behaviour. The tax deductibility of interest payments on debt gives private-equity executives an incentive to pile extra debt onto the companies they buy, thereby risking the health of these firms for the sake of a tax benefit and the prospect of higher returns.

There is another way in which the tax code is responsible for allowing private-equity types to walk off with vast bounties. Their profits, called “carried interest”, are taxed as capital gains, which incur a lower rate than income does. People who work in the business maintain that carried interest is investment income, but most of the capital at risk is that of investors, not their own.

Politicians in America and Britain, who have been debating this loophole since 2007, should close it. Carried interest is really a bonus and should be taxed like one.

There is a third charge against private equity, to which the industry's critics have paid little attention. It relates to the returns the industry delivers: investors have more reason to complain about private equity than do voters.

The industry has seduced investors with the promise of outstanding returns. But there is no clear evidence that private equity outperforms public markets (see article). Once the exorbitant fees are taken into account, returns look much less impressive than the industry's promoters claim, and than an illiquid, leveraged and long-duration investment would warrant.

Looking ahead, returns are likely to be even worse. Buy-out executives themselves admit that performance will be more ordinary in future, since debt, which powered private-equity firms' profits, won't quickly return to pre-crisis levels. The performance of funds which did well in the bubble era is likely to be unimpressive in tighter times. Public pensions, which provide more than a quarter of buy-out firms' assets, should take note as they choose their future investments.

Link para o artigo: http://www.economist.com/node/21543545?frsc=dg|a