Private equity under scrutiny

Bain or blessing?

The buy-out industry is under attack for destroying jobs. Its returns to investors are the real problem

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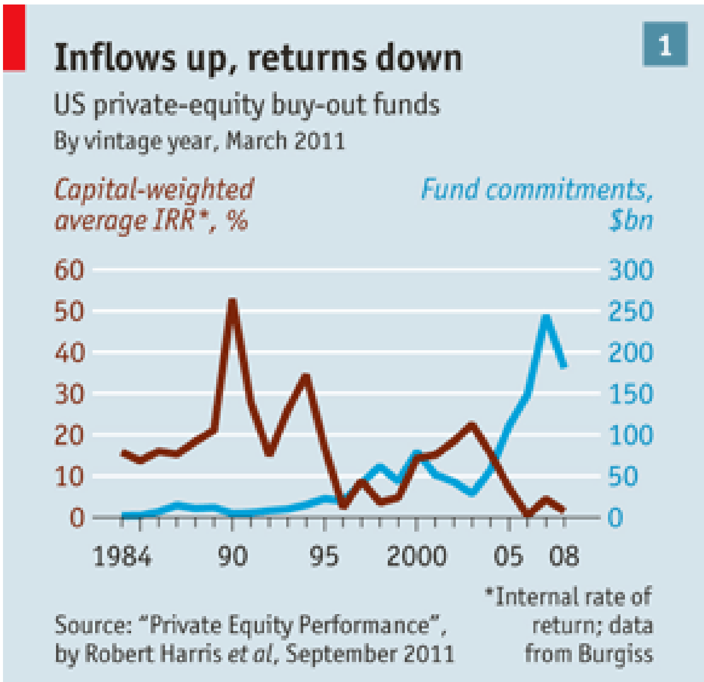
IF STEVE SCHWARZMAN thought it was valid in 2010 to compare Barack Obama's "war" against business to Hitler's invasion of Poland, what can he be thinking now? Private-equity executives must be hoping the boss of Blackstone will keep his opinions to himself. More bad publicity is the last thing the industry needs. Other Republican presidential candidates are competing to see who can say the most damning thing about Mitt Romney's career at Bain Capital. Newt Gingrich's supporters have even made a sort of horror movie about what happens when private-equity firms like Bain Capital get their hands on otherwise healthy companies.

The buy-out bit of the industry, which buys mature companies, fixes them up and sells them on, is the one on trial (few have a bad word for venture capital, which invests in start-ups). It is charged with destroying the jobs of ordinary people while enriching the likes of Mr Romney.

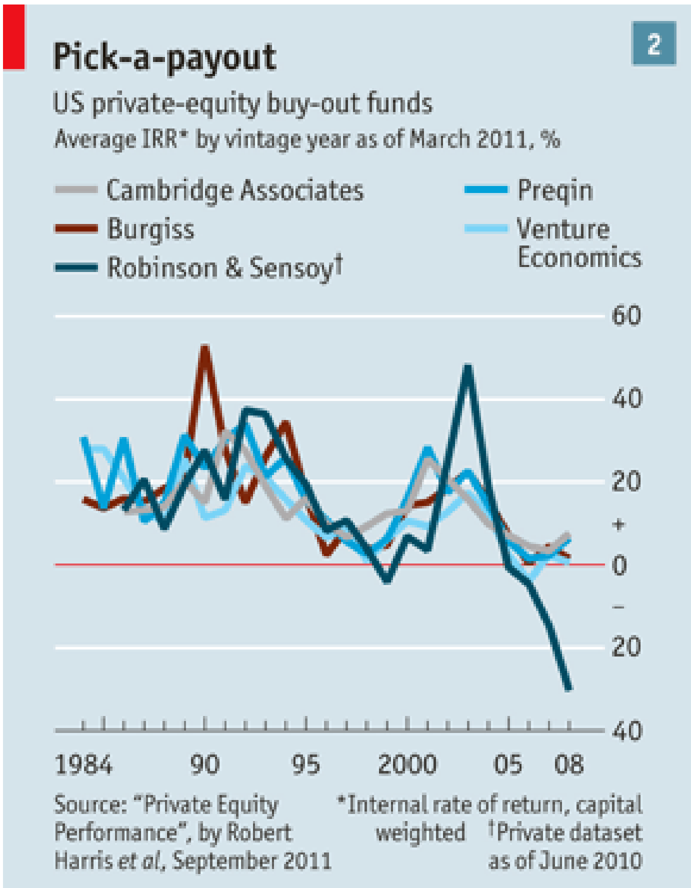
Examples of dud deals are not hard to come by. The tax code's treatment of debt (with interest on debt payments being tax-deductible) and private equity's thirst for profits have at times driven the industry to saddle companies with too much debt.

Between 2004 and 2011 private-equity firms heaped more debt on their companies so they could take out a staggering $188 billion in dividends for themselves, according to Standard & Poor's Leveraged Commentary & Data, which tracks the industry.



But private equity isn't employment's grim reaper. Buy-out firms usually set their sights on companies that they can improve, which means they may buy weaker or more bloated ones in the first place. A recent NBER working paper looked at employment after 3,200 leveraged buy-outs in America. It found that private-equity ownership resulted in both more rapid job destruction and faster job creation than other forms of ownership. Two years after a buy-out, employment declines by 3% on average; if acquisitions, divestitures and new sites are included the losses are only 1% of initial employment. Other research has found that wages do not rise as quickly at private-equity-owned firms, probably because buy-out firms try to control costs after a takeover. But wages also don't plummet, which may be why unions that used to oppose buy-outs have moderated their criticisms.

In any case, it is not the mission of buy-out firms to create jobs. Their mandate is to produce higher risk-adjusted returns, and this is where private-equity firms should be judged more harshly. The industry has long boasted about its earth-shattering performance. Investors, and public-pension funds in particular, have piled into the asset class. But the bulk of investors' capital has gone into funds that were raised when asset prices were at peak levels (see chart 1). Although fears of a bloodbath among bubble-era buy-outs have not yet been realised, returns for most of these funds are going to be middling at best.



Nor is there conclusive evidence that private equity consistently outperforms public companies, although certain high-performing firms undoubtedly do. A recent attempt to analyse private-equity performance, by Robert Harris of the University of Virginia's Darden School, Tim Jenkinson of Oxford University's Saïd Business School and Steven Kaplan of the University of Chicago's Booth School of Business, concludes that it is "very likely" that private equity outperforms the S&P 500 (after fees). But the outcome looks different depending on which database is used. These vary wildly (see chart 2), and none has returns for all funds. The study emphasises a new data set, which could make things look rosier because the worst-performing funds may not be sufficiently represented.

The bigger issue

There is also a question about how private-equity firms calculate their returns. The internal rate of return (IRR) is the usual measure. But according to a 2010 study by Peter Morris, a former banker, entitled “Private Equity, Public Loss?”, it is rare for two firms to calculate IRR in the same way. This can complicate any attempt to compare funds. IRRs can also overstate the actual returns investors realised, according to Ludovic Phalippou at Amsterdam Business School, since the measure implies that the return was achieved on all the investor’s cash, even if some of it was given back early and reinvested at a lower rate.

The S&P 500 may not even be a fair benchmark for private-equity firms, says Mr Phalippou, since most buy-out firms purchase midsized companies, which have performed better than the big firms included in the S&P 500. An index of mid-cap stocks could offer a more accurate comparison, but also a higher hurdle for private-equity firms to jump.

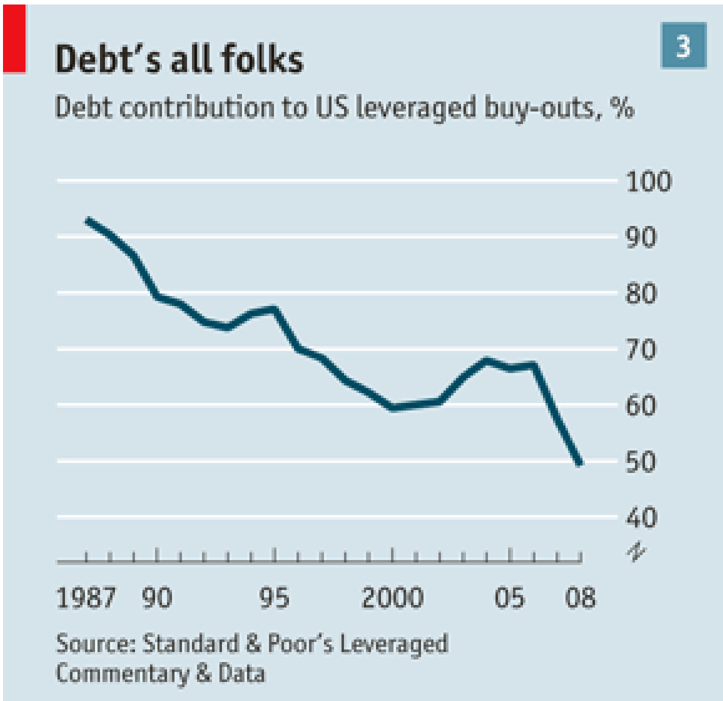
Why would investors put money with private-equity managers who aren’t that good? It could be that investors herd mindlessly into asset classes. But some of it may also reflect the way the industry manipulates data. “Every private-equity firm you talk to is first-quartile,” quips Gordon Fyfe, the boss of PSP Investments, a C$58 billion ($58 billion) Canadian pension fund.

Oliver Gottschalg of HEC School of Management in Paris looked at 500 funds, and 66% of them could claim to be in the top quartile depending on what “vintage year” they said their fund was. The vintage year is supposed to be when the fund has its final “close” and stops fund-raising. But some firms may decide to use the year they started raising the fund or had their first “soft” close (when a fund is no longer officially open to new money), if it allows them a more favourable benchmark.

If investors can work out a way to place their money with funds that are actually in the top quartile, it is probably worth the fees and the extra risk of investing in this illiquid, leveraged asset class. But that is a big if. David Swensen, the man who runs Yale's $19.4 billion endowment and a noted proponent of alternative investments, has written that "in the absence of truly superior fund-selection skills (or extraordinary luck), investors should stay far, far away from private-equity investments."

Abuzz about fees

Buy-out executives have always claimed their interests are perfectly aligned with those of their investors, since they can only eat if their investors do. But that has changed as private-equity firms have morphed from small outfits into behemoths managing billions of dollars. Private-equity firms usually charge a 2% annual fee to manage investors' capital and then take 20% of the profits. Big firms can now support themselves just from management fees. A study by Andrew Metrick at Yale School of Management and Ayako Yasuda at the University of California, Davis finds that private-equity firms now get around two-thirds of their revenues from fixed fees, regardless of performance.



If all that wasn't bad enough for investors, the prospects for future returns look dim. Higher debt has accounted for as much as 50% of private equity's returns in the past, according to a 2011 study co-written by Viral Acharya of New York University's Stern School of Business. But banks are not lending as much as they did five years ago, increasing the amount of equity that firms are having to stump up (see chart 3). That will cap returns. "Employees are going to make less money, and firms are going to make less money. Returns are going to be much more mundane," is the gloomy prediction of the boss of one of the largest private-equity firms.

Prices have also remained painfully high. Last year the average purchase-price multiple for firms bought by private equity was 8.4 times earnings before interest, tax, depreciation and amortisation, higher than it was in 2006. That's because the industry is sitting on $370 billion in unused funds, or "dry powder", that firms need to spend soon or risk giving back to investors, which means there is fierce competition for deals. Many transactions are between private-equity firms, which does little good to investors who have placed money with both the seller and the buyer.

With the option of financial engineering basically gone, private-equity firms have no choice but to improve the businesses they buy. Every private-equity firm boasts about its "operational" skills but sceptics question whether private-equity executives are that good at running companies. A senior adviser at a big buy-out firm and former boss of a company that was bought by private equity says he disagrees that buy-out executives are good managers of businesses: "They're even less in touch with the real world than public-company managers. They're a group of very clever, very analytical people paid lots of money whose general feel for the businesses is pretty poor." Their edge, he says, comes from having a fixed investment term, which helps focus managers' minds.

With the landscape bleaker than it was, many private-equity firms are reinventing themselves. Most buy-out firms now prefer the fluffy title of “alternative asset manager”. They have started to do more “growth equity” deals, taking minority stakes in companies and using less debt. This has been their strategy in emerging markets like China, where control and highly leveraged deals are not as welcome, but now the approach is also increasingly being used in the West. Big American firms like KKR, Carlyle and Blackstone have all expanded or started other units focused on things like property, hedge funds and distressed debt.

Many private-equity firms will quietly fade away, although Boston Consulting Group’s infamous prediction in 2008 that 20-40% of the 100 largest buy-out firms would go extinct has not yet come true. That is probably because private-equity firms take a long time to die. There are 827 buy-out firms globally, according to Preqin, a research firm. They will not all be able to raise another fund. European private-equity firms are particularly vulnerable because they have not diversified as much as their American competitors.

But Mr Romney’s candidacy will ensure that American firms feel more political heat. Executives’ special tax treatment, under which their profits are taxed as capital gains rather than income, will almost certainly go. The limelight has not yet scared off the 236 buy-out funds that are in the market trying to raise another $172 billion. But it is not as much fun as it was. “Back in 2005 fund-raising was like having a velvet carpet with a rope,” says one buy-out boss. “You had a bouncer and only let the prettiest people in. Now it’s buy one, get one free, and free entrance before 11.”

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