5. Critics and the research

In this section, in the context of resurgence in the private equity market, we draw together the major criticisms levelled at the sector during the boom years of 2006–2008. We clarify some misrepresentations and myths in the light of experience over the last six years to 2014 and the weight of systematic evidence summarised in this publication.

Several years ago, we published an assessment of the criticisms levelled at the private equity sector in *Private Equity Demystified – An explanatory guid*e. In this, the third edition of that work, we are able to further evaluate the criticisms using evidence and experience accumulated since then. That evidence is also summarised in this publication.

5.1 Is private equity about majority acquisitions of large listed corporations?

While majority acquisitions by private equity firms of listed corporations tend to attract considerable media attention, these deals are only part of the private equity market. Even in the boom years they accounted for only about 4% of deal numbers. This is less than a quarter of deal value across Europe. In 2013, these public company transactions accounted for less than 5% of total deal value in Europe.

In contrast, the largest single source of deal numbers across Europe has traditionally involved buy-outs of private/family firms, followed by divestments and secondary buy-outs. The largest single source of deal value has traditionally been corporate divestments. However, recently secondary buy-outs have taken the top position.

5.2 Does private equity create systemic risk?

A long-standing criticism dating back to the first private equity wave in the 1980s is that the higher leverage in private equity deals was likely to have adverse systemic implications. The traditional private equity fund structure operates to limit systemic risk by offering long-term, illiquid, unleveraged investment assets to investors with large diversified portfolios. The private equity industry did generate increased demand for debt during the second private equity wave. However, the contribution of industry to the market failures seen in 2007–2008 arose through failures in the associated acquisition finance banking market, not within the private equity fund structures. In the future, pressure to increase leverage within funds and to provide liquidity to investors may lead to geared private equity funds which would lead to increased systemic risk.

5.3 What happened to the 'wall of debt'?

Many commentators forecast that the debt raised by buy-outs in the boom years would precipitate a secondary crisis when it came to be refinanced. This so-called 'wall of debt to be refinanced' has effectively been dealt with. The practice of 'pretend and extend', whereby loans are rolled over despite being behind the original plan, has gone some way to pushing the supposed problem into the future. At the time of writing, an increasing appetite by banks, bond holders and non-bank lenders to grow their business lending books again has led to an increase in debt availability. Furthermore, cov-lite is also re-emerging. We would caution that if this trend were to accelerate, problems may be created for the future in particular where cov-lite does not provide for a syndicate to act as one.

5.4 Is there excessive debt and are there gains from leverage?

Critics also argued that many deals were being completed in the boom years with levels of debt that were too high. Using 'excessive' levels of debt to acquire corporations generates risks. The argument is that these risks are borne by the wide stakeholders of the business including both employees and creditors. Neither of these groups benefit from the increased rewards that this risk generates.

Attribution studies show that while some gains derive from the leverage in private equity deals, the largest proportion comes from fundamental improvements to the business. It is not clear whether this reflects good stock picking (ie, the extent to which private equity firms are good at selecting good deals) or good operational management post transaction (ie, whether they add value once they have made an investment) or both.

When we look at the risk element in the equation, our review of the evidence indicates that after taking other factors into account, private equity-backed firms are not significantly more likely to enter formal bankruptcy proceedings (administration) than non-private equity-backed companies. Recent evidence based on the population of UK-limited companies has also found that during the period 2008–2011, and taking into account firm-specific, industry and macroeconomic factors, private equity-backed buy-outs reported significantly higher profitability and cumulative average growth rates than non-private equity-backed private companies. These findings suggest that private equity-backed firms' underlying performance held up better during the recession than that of non-private equity-backed private companies.

5.5 Does the industry suffer from short-termism and do private equity buy-outs result in underinvestment?

Major strands of the critique of private equity were that it was about cutting jobs, stripping assets, derecognising unions and exiting the business in a short time horizon. The significant body of systematic evidence now available shows that this view is too simplistic. Rather, private equity deals are varied and heterogeneous in terms of their strategies and timescales. In Figure 5.1 we try to simplify this variety contrasting timescales and strategies.

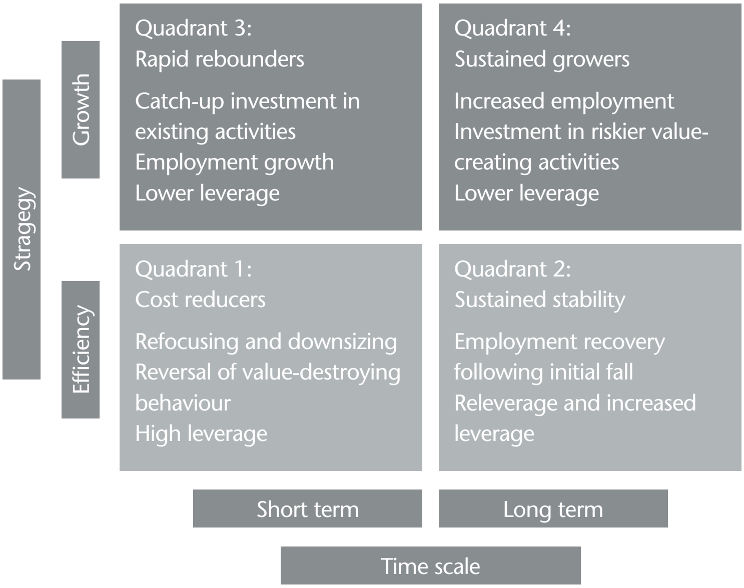
Some investments do involve cost reduction. This may be the reversal of value-destroying behaviour in order to improve efficiency over a short time period (quadrant 1). This type of 'one-off' shock therapy was probably more typical of the first wave of private equity-backed buy-outs. In these types of transaction the management of the company are supported by the private equity firm in introducing financial and governance processes that eliminate waste and improve efficiency.

A secondary category of transaction (quadrant 2) is a longer-term strategic repositioning. We might characterise these as transactions where a company needs to take a step back to take two steps forward. This is notoriously difficult to achieve as a quoted company, or as part of a quoted company, where stable earnings growth is highly valued. These situations often involve initial falls in employment and radical cost reduction in failing business lines alongside investment in the streams that will support future growth. The idea is to rebuild the base for a more stable business over the longer term that can recover employment and profitability and return to a more stable earnings pattern.

The two other categories of transaction involve growth strategies rather than cost cutting and reconstruction. Where businesses have been capital constrained by their owners a private equity-backed buy-out may provide the opportunity for catch-up investment that generates a step change in the business in relatively short order (quadrant 3).

Finally, some investments are made based on longer-term growth strategies (quadrant 4). Clearly this type of investment is constrained if a traditional 10-year fund is the investor, but there are funds that are structured to take a longer-term view, although this is not the norm.

Figure 5.1: Buy-out types, strategy and timescale



5.6 Is there a lack of employee consultation in private equity-owned firms?

Concerns about lack of consultation with workers relates to both prior to and after a private equity acquisition. This criticism gets caught up with the TUPE issue (see section 2.3). Because private equity usually involves both a transaction and a change or refocusing of strategy, there are huge changes in the business, both real and perceived. It may well be good commercial practice to consult with some wider stakeholder groups about these changes, but there is no reason to believe that consulting in and of itself is socially desirable or effective and therefore should be a requirement. It is clear that a change of ownership necessarily entails uncertain times for many people. There is no evidence that we are aware of that the cohort of companies owned by private equity consult more or less than any other business in a similar change of ownership.

Furthermore, we are not aware of any evidence-based consensus that such a consultative process is correlated with the economic and social outcomes of any investment or group of investments.

If we take the consensus from the evidence bases on corporate mergers and acquisitions (M&A) and private equity, we arrive at a very different conclusion. It is widely believed that M&A by corporates tends to be unsuccessful in generating shareholder value. It is also, less strongly, believed that private equity has generated returns that are higher than quoted companies. Therefore, the question for research is not whether private equity style transactions should change their management approach, but rather why are corporations worse at mergers and acquisitions than private equity investors?

5.7 Is there tax avoidance and why are tax havens used?

There are two threads to these criticisms. The first revolves around the deductibility of interest paid on loans borrowed to fund buy-outs. While the position varies from country to country, the general position is similar. Whereas in the past most interest was deductible, for many years in most countries this has no longer been the case. All tax authorities acted to stop abuse by using excessive levels of debt. The critics who raise this argument are often unaware that authorities acted to deal with the issue many years ago.

The second, more general criticism is that both investee companies and the private equity funds themselves adopt artificial and convoluted structures to reduce tax in ways that are legal but not available to others and therefore unfairly favour private equity. This is wrong in detail. Many of the apparently artificial structures have nothing to do with tax. They are designed within the confines of countries' laws to manage liabilities as well as taxation.

There are no particular arrangements available to private equity funds that are not available to others. Therefore the debate about offshore and international taxation is a manifestation of a more general debate, outside the scope of this commentary, about the taxation of corporations and individuals generally.

Our only observation is that the critics do not seem to be arguing that any laws are being broken. They appear to be arguing that the laws are wrong or wrongly interpreted. That is surely a matter for politicians and legislators. Businesses are not directly responsible for the regulatory framework and nor should they be.

5.8 Is there a culture of secrecy?

There are concerns about a lack of public information on the funds and their investors. If private equity funds intended to be secretive, they have been very poor at achieving it. The number of papers on private equity in academia goes back to the early 1980s and continues to grow.

Similarly, the public commercial data sources are extensive and growing. The level of interest has tracked the growth of the industry, just as it would in any similar growth area with reported high returns. Doubtless some organisations and individuals have raised their profiles and with them that of the industry in general. However, it is our contention that private equity was not secretive but simply not forthcoming with information to a largely disinterested public. This was not due to any strategy to avoid openness, but rather due to the absence of any communication strategy at all with the wider public. In an industry that has grown from a few small transactions in the 1980s to many global fund managers in some 30 plus years, it is not surprising that an information void appeared. This void is being filled.

5.9 Is there overpayment of executives?

There are widespread criticisms of the compensation of partners and staff of the funds. The criticism is that people are paid too much and that it cannot reflect the real economic worth of those individuals. There are two separate issues to consider in this criticism. Firstly, there is the return to the founders of the private equity companies. This reflects the reward for establishing and building major global financial institutions in less than a generation. Secondly, and unrelated, is the return to those who joined the firms when the firms had become established and successful.

5.10 Is there sufficient permanent capital in private equity funds?

There were concerns regarding the minimum regulatory capital requirement of fund structures. These were largely misplaced as industry norms for 10-year commitments ensure funds are 100% equity backed. The concern was more appropriate for non-private equity funds and indeed once clarity over the difference in fund structures was understood, the regulators incorporated changes to acknowledge the differences between most private equity funds and, say, hedge funds. It was a good example of a problem that now seems to have abated: journalists and commentators now rarely conflate private equity and hedge funds. They are totally different ways of generating returns. They are no more alike than walking and roller-skating are similar ways of making a journey.

5.11 Is there a misalignment of incentives?

Not all of the critics are ideologically opposed to the industry. Criticisms concerning misalignment of incentives have arisen from among those actively involved in private equity. The central assumption of private equity is that shareholders' interests should be the primary concern of the management of any company. While it may sound controversial to some, this is simply a restatement of the basic responsibilities of any director of a 'for profit' limited company. The shareholders own the business and management are duty bound to act in the interests of the shareholders, subject to the constraint that they must not trade when insolvent and must observe the various rights of employees, customers and other groups. However, there are a number of circumstances where the interests of the various parties in a leveraged transaction may not be aligned.

5.11.1 Fund level fees

Investors in private equity have been vocal in their concern that the original tightly aligned model of the industry has been materially weakened as funds have become larger and have become multi-fund managers. A small private equity fund relies heavily on sharing in capital gains to generate wealth for its partners. Large multi-fund managers may be more motivated by the fees generated than the outcomes achieved. Fees have become larger as funds have grown, and the excess of fees over fund costs has grown in absolute terms providing a higher guaranteed income to the manager and therefore, probably, higher profit to its partners.

Therefore, there is an incentive to maximise the fund size (consistent with the investment opportunities for the fund) in order to increase the management fee income. Critics have argued that as fund size has grown, the funds' costs have grown less rapidly. Therefore the profit from fee income has become material. It is argued that this income, which is effectively guaranteed, has created a misalignment between the partners in private equity funds and their investors. In essence a new principal–agent problem is said to have been created by the high levels of guaranteed income from fees.

5.11.2 Transaction fees

These are arrangement fees charged by the fund as opposed to fees payable to transaction advisers. They represent inefficiency in the private equity banking market. Investors' money is invested into a transaction and immediately repaid to the fund managers and/or the fund. Increasingly investors are putting pressure on fund managers to direct these fees to the fund not the fund manager.

5.11.3 Zombie funds

As funds have started to 'fail', the incentives of the various parties have diverged and some perverse incentives have emerged. The likelihood of a private equity fund failing is examined in section 2.1.16. Essentially, where a manager will not be able to raise a new fund and the investments will not generate carried interest, the motivation of the manager can be to do as little as possible, for as long as possible.

5.11.4 Late fund stuffing

As funds approach the end of their investment period, there is a strong incentive to invest committed capital rather than cancel it. This is particularly intense where the fund is poorly performing or the likelihood of raising a new fund is low. There is research to suggest that secondary transactions completed late in the investment life of funds show significantly lower returns than the overall population of private equity-backed investments. This would be consistent with the 'late stuffing' conjecture.

5.11.5 Equity illusion

Management of investee companies may suffer from 'equity illusion'. They may hold a significant proportion of the equity of the business (a large 'equity percentage'). However, they may have so much investment ranking ahead of them that has to be repaid before any value is shared by the equity that they cannot realistically accrue any value in their apparent equity stake. In this scenario management are no longer aligned with the private equity sponsors. This misalignment arises where investors take a priority yield that may effectively appropriate equity value to the private equity fund.

5.11.6 Time value of money

Management teams are typically interested in the absolute amount of capital gain whereas private equity funds may target a return on their investment. This can create differences in exit strategy between shareholders and managers due to the time value of money.

5.11.7 Funding acquisitions

Acquisitions often require further equity funding. Where this dilutes management equity or puts instruments that have a priority return to equity into the capital structure, incentives may change.

5.11.8 Credit default swaps

Hedging techniques have created potentially perverse incentives for purchasers or holders of debt in distressed companies. Where loans are publicly traded, purchasers of loans that are 'guaranteed' using credit default swaps may be incentivised to bring about a loan default rather than avoid one. They may therefore be incentivised to induce failure.

5.11.9 Valuation of unrealised investments

Private equity managers are fund managers who seek to raise a series of funds. Due to the long-term nature of the funds and the unquoted nature of the investments made, the ultimate returns on any fund are not known until the fund is fully realised. This will fall outside the usual six-year investment horizon. Therefore, the valuation of the unrealised investments in any existing fund will be an important influence on the decision of existing and new investors looking to invest in any new fund. There is a material incentive to flatter the returns of unrealised fund investments when fund-raising. There is some evidence that this occurs.

5.12 Do the conclusions to be reached about private equity depend on the evidence base?

What becomes clear from our review of the claims and counterclaims about private equity is that it is critical to be careful about the evidence base being used. The evidence base may be flawed or may apply to only a particular part of the private equity market.

The use of specific cases to draw general conclusions about the effects of private equity on employment and employee relations is self-evidently discredited. Additionally, some of the cases either did not demonstrate the problem being claimed or took a short-term perspective. For example, in some cases it was unclear what would have happened in the absence of the buy-out.

With respect to more quantitative analyses, problems have arisen because in many jurisdictions performance data is not readily available for private companies. Where such data is used it may be biased if it either refers to higher-performing companies coming to market and hence is disclosing data on their performance as a private firm in the flotation prospectus or relates to the larger end of the market which uses public debt.

Because of the difficulties in obtaining data on the performance of private equity funds and portfolio companies, many studies have made use of proprietary databases. While these do provide rich access to data otherwise unavailable, it has recently become clear that some of these are quite flawed, for example in terms of measures used and whether or not data has been updated. This is an important issue because the impact is not simply a question of minor differences in the same direction of findings but directionally in terms of whether private equity funds have under- or overperformed.

Some other quantitative studies have sought to draw general conclusions about the performance of private equity-backed portfolio companies when they are only referring to a part of the private equity market, such as larger deals or majority private equity owned MBIs/IBOs.

For the future, studies can do more to be clear about the limitations and boundaries of their datasets. Replication studies can also help build up a reliable picture but questions still remain if significant parts of the market are still systematically omitted. In general, there is a greater need for representative studies covering the whole private equity-backed buy-out population that allows comparison with non-private equity-backed companies after controlling for other factors as far as possible. Compared to the US, for example, the UK offers an important context where such studies are feasible since accounting data is available on private companies generally and non-private equity-backed buy-outs can be identified.

5.13 What are the areas for further research?

Despite the extensive body of systematic evidence now available, further areas for research remain. The following represent a non-exhaustive list of areas warranting further examination:

- What are the most effective board compositions for different types of private equity buy-out?
- What are the relative performance effects of buy-outs and buy-ins involving private equity firms that are more or less actively involved in their portfolio firms?
- What have been the effects on employee relations and human resource management in private equity-backed buy-outs during and subsequent to the post-2008 recession?

- What are the relative contributions of different forms of innovation versus cost restructurings to the growth of private equity-backed buy-outs?
- To what extent do private equity firms learn from their experience over time to enhance the effectiveness of their involvement in portfolio firms?
- How are private equity firms adapting their exit plans as resurgence of economic growth reopens opportunities that were constrained during the recession? To the extent that there are now more attractive opportunities to secondary buy-outs, what are the implications of these developments for the availability of new investment opportunities?
- To what extent and how are private equity firms adapting their approaches to secondary buy-outs in the light of evidence regarding their performance effects?
- What are the outcomes from secondary fund purchases at both the fund and underlying portfolio company levels? How do these outcomes compare with those associated with primary funds?'