Private Equity: Beyond the “storytelling”

Aswath Damodaran

Home page: http://www.damodaran.com
Twitter: @AswathDamodaran
Blog: http://aswathdamodaran.blogspot.com
The “private equity” debate: Key questions

1. What is private equity investing?
2. Who are these “private” equity investors?
3. Who do they target?
4. What do they do at these targets?
5. Do they make money?
6. Do they do good or bad?
What is private equity?
To understand private equity, you have to go back to the basics.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of investments you have already made as a company over your history. Their value is updated to reflect their current cash flow potential.</td>
<td>Lenders, both short and long term, get first claim whatever cash flow is generated by the firm.</td>
</tr>
<tr>
<td>Assets in Place</td>
<td>Debt</td>
</tr>
<tr>
<td>Growth Assets</td>
<td>Equity</td>
</tr>
<tr>
<td>Value of investments you expect the company to take into the future. This value rests on perceptions of the opportunities you see for the firm.</td>
<td>Equity investors get whatever is left over, after meeting the debt obligations.</td>
</tr>
</tbody>
</table>

Sources of equity
Private: Owner, Venture Capital, Institutions
Public: Stockholders (individual, institutional)
An idea business to IPO

Start-up
- Owner 100%

Build-up
- VC 40%
- Owner 60%

IPO
- Public 25%
- VC 30%
- Owner 45%
A public company matures...
A real world picture...
The “corporate governance” and “market” problems...

Mature public

1. Market may be mispricing the firm
2. The company may be operating in a “bad” business or its business model could be broken.
3. The company may be mismanaged.
And there are lots of “poor” performing companies in the market.
A “road map” for “value” creation

Status Quo Value
Intrinsic value of firm with existing management

X

Value Gap

Optimal Value
Intrinsic value with "best" management in place

1 - Probability (Management Change)

Probability (Management Change)

Market Value

Pricing Gap

Expected value = Status Quo value (1 - Prob(chg)) + Optimal Value (Prob(change))
Provide an entrée for private equity

Mature public

- Public: 96%
- Insider(s)

Private equity

- Private equity: GP Equity: 25%
- Private equity: LP Equity: 20%
- Insider(s): 15%

Gets “key” managers to buy in as “equity” investors.

The general partners (GP) of the PE firm raise equity capital from limited partner (LP) “equity investors and borrow the rest.
## The timeline for PE... with risks at each stage

<table>
<thead>
<tr>
<th>Event</th>
<th>Details</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;Public&quot; company</td>
<td>acquired with mix of debt &amp; equity and taken private</td>
<td>1. Wrong target&lt;br&gt;2. Too high a price</td>
</tr>
<tr>
<td>Run as a private company, with changes made to asset mix and operations</td>
<td>Private equity investors come up with the equity portion of the transaction</td>
<td>1. Asset sales disappoint&lt;br&gt;2. Too much debt</td>
</tr>
<tr>
<td>&quot;Fixed&quot; company</td>
<td>taken back public or sold to a public company.</td>
<td>Market/Sector weakness leads to poor exit values</td>
</tr>
<tr>
<td>Private equity investors provide &quot;management&quot; and &quot;strategic&quot; input, and receive management fees and residual cash payouts.</td>
<td>Private equity investors provide &quot;management&quot; and &quot;strategic&quot; input, and receive management fees and residual cash payouts.</td>
<td></td>
</tr>
</tbody>
</table>
Who are these “private” equity investors?
Private equity has grown over time... but remains cyclical

US Buyout Deal value: 1980-2011

Credit bubble & Cheap debt

Conglomerate inefficiency & Junk bond markets

Strong economy & rising markets
And it is an increasingly global phenomenon

Global buyout deal value

$800B

Notes: Excludes add-ons, loan-to-own transactions and acquisitions of bankrupt assets; based on announcement data; includes announced deals that are completed or pending, with data subject to change; geography based on the location of targets. Source: Dealogic
With Emerging Market companies leading the way…

Emerging-market PE capital investment by region 2007–Q3 2011

Notes: Includes equity capital invested (excludes debt); excludes real estate, infrastructure and secondary transactions; excludes activity by hedge funds, captive funds and government-backed funds. Emerging Asia excludes Australia, New Zealand and Japan. Source: EMPEA
Here are the biggest players...

<table>
<thead>
<tr>
<th>Rank</th>
<th>Fund Manager</th>
<th>Headquarters</th>
<th>PEI 300 Five-Year Fundraising Total (m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>TPG</td>
<td>Fort Worth (Texas)</td>
<td>$49,897.00</td>
</tr>
<tr>
<td>2</td>
<td>The Blackstone Group</td>
<td>New York</td>
<td>$49,638.30</td>
</tr>
<tr>
<td>3</td>
<td>Kohlberg Kravis Roberts</td>
<td>New York</td>
<td>$47,689.87</td>
</tr>
<tr>
<td>4</td>
<td>Goldman Sachs Principal Investment Area</td>
<td>New York</td>
<td>$43,469.25</td>
</tr>
<tr>
<td>5</td>
<td>The Carlyle Group</td>
<td>Washington, DC</td>
<td>$30,741.39</td>
</tr>
<tr>
<td>6</td>
<td>CVC Capital Partners</td>
<td>London</td>
<td>$25,068.77</td>
</tr>
<tr>
<td>7</td>
<td>Apax Partners</td>
<td>London</td>
<td>$22,823.88</td>
</tr>
<tr>
<td>8</td>
<td>Apollo Global Management</td>
<td>New York</td>
<td>$21,035.00</td>
</tr>
<tr>
<td>9</td>
<td>Bain Capital</td>
<td>Boston</td>
<td>$21,033.49</td>
</tr>
<tr>
<td>10</td>
<td>Oaktree Capital Management</td>
<td>Los Angeles</td>
<td>$17,632.31</td>
</tr>
<tr>
<td>11</td>
<td>Hellman &amp; Friedman</td>
<td>San Francisco</td>
<td>$17,200.00</td>
</tr>
<tr>
<td>12</td>
<td>General Atlantic</td>
<td>Greenwich (Connecticut)</td>
<td>$16,800.00</td>
</tr>
<tr>
<td>13</td>
<td>Providence Equity Partners</td>
<td>Providence (Rhode Island)</td>
<td>$16,300.00</td>
</tr>
<tr>
<td>14</td>
<td>Cerberus Capital Management</td>
<td>New York</td>
<td>$15,900.00</td>
</tr>
</tbody>
</table>
But many of these institutions have individuals behind them...

<table>
<thead>
<tr>
<th>Activist Investor</th>
<th>Firm</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brett Icahn</td>
<td>Icahn Associates (Carl Icahn)</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Bryant Riley</td>
<td>Riley Investment Management</td>
<td>Los Angeles, CA</td>
</tr>
<tr>
<td>Carl Icahn</td>
<td>Icahn Associates (Carl Icahn)</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Chris Hohn</td>
<td>The Children's Investment Fund Mgmt</td>
<td>London</td>
</tr>
<tr>
<td>Clay Liffander</td>
<td>Millbrook Capital Management (MML)</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Daniel Loeb</td>
<td>Third Point Management Company</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Dr. Joseph Mark Mobius</td>
<td>Templeton Asset Management</td>
<td>Singapore</td>
</tr>
<tr>
<td>Ed Bosek</td>
<td>Beacon Light Capital</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Glenn Greenberg</td>
<td>Brave Warrior Advisors</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Glenn J. Krevlin</td>
<td>Glenhill Capital Management LLC</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Gregory Taxin</td>
<td>Spotlight Capital Management</td>
<td>New York, NY</td>
</tr>
<tr>
<td>John S. Dyson</td>
<td>Millbrook Capital Management (MML)</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Mario D. Cibelli</td>
<td>Cibelli Capital Management</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Mario J. Gabelli</td>
<td>GAMCO Asset Management</td>
<td>Rye, NY</td>
</tr>
<tr>
<td>Mark N. Lampert</td>
<td>Biotechnology Value Fund Partners</td>
<td>Chicago, IL</td>
</tr>
<tr>
<td>Max Holmes</td>
<td>Plainfield Asset Management LLC</td>
<td>Stanford, CT</td>
</tr>
<tr>
<td>Nelson Peltz</td>
<td>Trian Group</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Peter Schoenfeld</td>
<td>P. Schoenfeld Asset Management LLC</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Philip Falcone</td>
<td>Harbinger Capital Partners LLC</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Ralph Whitworth</td>
<td>Relational Investors LLC</td>
<td>San Diego, CA</td>
</tr>
<tr>
<td>Richard Breeden</td>
<td>Breeden Capital Management</td>
<td>Greenwich, CT</td>
</tr>
<tr>
<td>Richard Robe</td>
<td>Arcadia Capital Advisors LLC</td>
<td>New York, NY</td>
</tr>
<tr>
<td>Rick Barry</td>
<td>Eastbourne Capital Management</td>
<td>San Rafael, CA</td>
</tr>
<tr>
<td>Stanley P. Gold</td>
<td>Shamrock Capital Advisors</td>
<td>Burbank, CA</td>
</tr>
<tr>
<td>Stephen A. Schwarzman</td>
<td>The Blackstone Group</td>
<td>New York, NY</td>
</tr>
<tr>
<td>T. Boone Pickens</td>
<td>BP Capital Management</td>
<td>Dallas, TX</td>
</tr>
<tr>
<td>Thomas R. Hudson Jr.</td>
<td>Doubleloon Capital LLC</td>
<td>Norwalk, CT</td>
</tr>
<tr>
<td>Whitney Tilson</td>
<td>T2 Partners LLC</td>
<td>New York, NY</td>
</tr>
<tr>
<td>William Edwards</td>
<td>Palo Alto Investors</td>
<td>Palo Alto, CA</td>
</tr>
</tbody>
</table>
Who do they target?
The typical target company in a PE buyout is one that is under performing its peer group in profitability and stock price performance, and with relatively small insider holdings.
And what are their reasons?

You have to be able to buy the target company at the right price.
And are spread around sectors...

**Americas PE due diligences (count by sector; 2011)**

<table>
<thead>
<tr>
<th>100%</th>
<th>Healthcare providers</th>
<th>Consumer electronics</th>
<th>Other</th>
<th>Household &amp; personal products</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>80</td>
<td>Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Chemicals</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Paper &amp; packaging</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Logistics &amp; transport</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>60</td>
<td>Automotive &amp; transportation vehicles</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>40</td>
<td>Construction &amp; building products</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>Machinery, equipment, systems &amp; controls</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>Industrial goods &amp; services</td>
<td>Healthcare</td>
<td>Technology</td>
<td>Retail</td>
<td>Consumer products</td>
</tr>
</tbody>
</table>

*Note: Includes all due diligences done, both for deals announced and not announced.*

*Source: Bain analysis*
And what do they try to do at these firms?
(1) How well do you manage your existing investments/assets?
   a. Cost cutting
   b. Asset divestitures
   c. Tax management
   d. Working capital management

Cashflows from existing assets
Cashflows before debt payments, but after taxes and reinvestment to maintain existing assets

(2) Are you investing optimally for future growth?
   a. If ROC < WACC, invest less
   b. If ROC > WACC, invest more

Growth from new investments
Growth created by making new investments; function of amount and quality of investments

(3) Is there scope for more efficient utilization of existing assets?

Efficiency Growth
Growth generated by using existing assets better

Expected Growth during high growth period

Length of the high growth period
Since value creating growth requires excess returns, this is a function of
- Magnitude of competitive advantages
- Sustainability of competitive advantages

Cost of capital to apply to discounting cashflows
Determined by
- Operating risk of the company
- Default risk of the company
- Mix of debt and equity used in financing

With young growth firms, start of the life cycle: Focus on (2)
With established growth firms, later in life cycle: Focus on (2, 4) and (5)
With mature firms, middle of life cycle: Focus on (1), (3) and (5)
With declining firms, end of life cycle: Focus on (1) and (5)
On the “governance” part... they push for changes

- **Board of directors:** The board of directors at target firms is picked by the equity investors in the buyout deal and therefore is more active in overseeing management.
  - Boards of the targeted firms tend to become smaller and meet more frequently after buyouts.
  - More of the directors are picked for their expertise in the target firm’s business

- **Top management:** While some of the managers in the target firm are part of the buyout team, there is also a greater push on accountability and compensation:
  - The likelihood of CEO turnover jumps at firms that have been, increasing 5.5% after the targeting. One study found that two-thirds of CEO of buyout companies were replaced within four years of buyout.
  - CEO compensation decreases in the targeted firms in the years after the activism, with pay tied more closely to performance.
On the operating end... less in invested back into existing businesses...

- The firms that are targeted by PE investors tend to be investing less in their businesses than their peer group even before the PE and there is a decline in that reinvestment after the PE.

- When growth firms are targeted by PE groups, there is no perceptible decrease in R&D and other investments after the buyout.
And there is asset redeployment

- There is an increase in divestitures, especially in non-core businesses, for firms with business sprawl.
- There is very little evidence of wanton stripping of assets for cash, i.e., the divestitures are generally not overboard are driven by the need to service debt.
- At the same time, many targeted firms find new businesses to invest in and change their asset mix.
Target firms come into buyouts with declining profitability in the two years prior but see improvements in the two years after, and more so in highly levered firms.
On the financial front... they do borrow money to finance the deal.

PE investors use more debt in funding transactions than other public companies.

Default risk increases as debt increases as % of value and cash flows.

Existing bondholders/lenders may be adversely affected, if they did not protect themselves.
But the PE record on default is only slightly worse than it is for non-PE firms with similar leverage...

Default rates: PE versus non-PE firms

PE firms are less likely to be liquidated (11% vs 16%) & stay in bankruptcy for shorter periods than non-PE firms.

One study found that only 1.2% of PE firms defaulted between 1980 & 2002. In contrast, the default rate across all publicly traded firms was 1.6%.
And on dividend policy, there is little evidence that PE firms strip firms and cash out...

- **Special dividends:** While there are some who fear that PE investors pay themselves large dividends right after they take over target firms, special dividends remain rare. A study of 788 private equity targets, tracked from 1993 to 2009 found only 42 instances of special dividends paid to PE investors.

- **Asset strips:** While there are undoubtedly some PE houses that turn target companies into ATMs, selling assets and drawing cash out of them, they are not the norm.
Do they make money?
When the transaction is announced...

Note: The solid line (left axis) plots the average buy-and-hold return around the Schedule 13D filing, in excess of the buy-and-hold return of the value-weight market, from 20 days prior the 13D file date to 20 days afterwards. The bars (right axis) plot the increase (in percentage points) in the share trading turnover during the same time window compared to the average turnover rate during the preceding (-100, -40) event window.
Ways for PE to generate profits from the transaction

- **Management fees:** When the PE investor runs the company as a private business, the company will pay management fees for the services rendered by the PE investor.

- **Make equity stake more valuable before exit:** By finding market mistakes, making operating fixed or through financial engineering, try to reap the difference in value at exit (by taking company back public or by selling in a private transaction).
Breaking down the returns to PE investors

Calculation of alpha for PE (Illustrative)

<table>
<thead>
<tr>
<th>Stock market return</th>
<th>Timing effect</th>
<th>Sector effect</th>
<th>Leverage effect</th>
<th>Comparable return after adjustments</th>
<th>Alpha</th>
<th>Return from the PE Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return that could have been earned in the same period on the stock market</td>
<td>Adjustment to reflect timing of cash flows (alignment of invested capital)</td>
<td>Adjustment to reflect the sector of the PE Investment</td>
<td>Adjustment to reflect the difference in leverage</td>
<td>Return from a comparable investment in shares after adjustments</td>
<td>Excess return of a PE investment relative to a comparable investment in shares</td>
<td>Return generated by the observed PE investment</td>
</tr>
</tbody>
</table>

Source: “Private Equity Study: Finding Alpha 2.0,” Oliver Gottschalg, HEC-Paris; Golding Capital Partners, November 2011
On average, PE investors deliver about 3% more each year than equivalent public investments.
But excess returns vary widely across PE investors..
And even the best PE investors lose sometimes... But make up with big winners

Distribution of gross deal returns for a sample of buyout funds by quartile

- Top quartile
- 2nd quartile
- 3rd quartile
- 4th quartile

Legend:
- Written off
- <1X
- At cost
- 1-2X
- 2-5X
- 5-10X
- >10X

Note: Analysis based on 117 mature buyout funds globally (>9 years old with at least 10 investments made);
investments were classified into performance quartiles based on fund TVPI; total of 2,973 investments (realized and unrealized)
Source: Preqin-HEC Report on Risk-Profile of PE Funds (forthcoming)
Is private equity a net good or net bad?

The “critiques”
The critiques of private equity

- **Use of debt exploits the tax code**: PE investors “unfairly” exploit the tax code’s tilt towards debt by borrowing large amounts to fund their deals.
- **PE profits are not taxed enough**: In particular, the “carried interest” should be taxed at ordinary tax rates, not capital gains rates.
- **PE investment destroys jobs**: Even if PE investors make companies more profitable, they do so by eliminating jobs.
- **PE is disruptive**: PE disrupts businesses, changing the way they are run and causing stress for those involved in these businesses.
Their “debt usage” exploits the tax code.

- It is true that private equity investors increase “debt” at the companies that they target and take private and do so because the tax code gives tax an advantage over equity.

- Note, though, that this tilt in the tax code is available to every company and to most investors and that the tax benefit given to debt does not imply that every business is better off borrowing more money. Debt does come with costs – bankruptcy and agency – that increase as you borrow more and at some point, the costs exceed the benefits.

- Bottom line: If you want to take issue with investors, businesses and individuals borrowing money because the tax code is tilted towards debt, your target should be those who write the tax code, not those who are governed by it.
And so does the treatment of “carried interest”

- Private equity fund managers (general partners) generally structure their “payoff” from “from other equity investors in the fund (limited partners) into two components:
  - A share of the “committed” capital under management (usually 2%)
  - A share of the “profits” (usually 20%) in the target firms, over and above what the they are entitled to on their equity holdings, that is categorized as carried interest. It is generally not paid out until the private equity fund exits the investment.

- Management fees are taxed as ordinary income and carried interest as capital gains. Critics argue that carried interest is really compensation for investment services and should be taxed as ordinary income. PE investors argue that it is “extra” return to compensate for the risk they face as general partners.

- Bottom line: Allowing PE investors to structure the deal as 2/20, you are allowing them to decide what portion is income and what portion is capital gains and to disguise what should be ordinary income as capital gains.
PE causes job losses... or does it?

- PE investors are viewed as job destroyers, who make their profits from shrinking companies and payroll.
- The evidence on PE job destruction is surprisingly murky. A study that looked at 3200 target firms between 1980 and 2005 found that while jobs were lost in the target, they were also created in new businesses that these firms entered:

Private Equity: Job destroyer & creator

<table>
<thead>
<tr>
<th>% jobs gained/lost relative to control group</th>
</tr>
</thead>
<tbody>
<tr>
<td>6%</td>
</tr>
<tr>
<td>4%</td>
</tr>
<tr>
<td>2%</td>
</tr>
<tr>
<td>0%</td>
</tr>
<tr>
<td>-2%</td>
</tr>
<tr>
<td>-4%</td>
</tr>
<tr>
<td>-6%</td>
</tr>
</tbody>
</table>

- Jobs lost
- Jobs created
- Net jobs
PE investors disrupt businesses.... But is that a bad thing?

- It is true that PE investors are a disruptive influence, causing big changes in the ways the businesses that they target are run and financed. That disruption comes with both social and economic costs.
- In some cases, the disruption can also create social costs that are not borne by the private equity investor. The social costs can range the spectrum from unemployment benefits/retraining costs for employees who get laid off to bigger costs if the government steps in as a lender of last resort or a back stop (too big to fail... too important to let go...)
- **Bottom line:** Socializing costs while privatizing benefits is a problem in any capitalist society. But disruption is the life blood of that society. Without creative destruction, you get stagnation and no innovation.
Imagine...

- Let’s say you buy into one or more of the critiques of private equity and feel that the only solution is to eliminate private equity. Imagine a world without private equity investors and ask the following questions:

  - **Micro questions**
    - Would managers at companies be relieved, indifferent or upset?
    - How would it impact employees at these companies?
    - What about customers?
    - What about stockholders and lenders?

  - **Macro questions**
    - Would we collect more tax revenue?
    - Would the overall economy be stronger or weaker?
    - Would we have more or less employment?
Closing thoughts…
In my view...

- Private equity investors can play a critical role in corporate governance by putting managers at publicly traded companies on notice. In the process, they can and will make money for themselves, but other investors can piggy back on their efforts.

- My problem with private equity investors is not that they are not “activist” enough in pushing for change at target companies and that they give up too easily when confronted with resistance.

- When they do make changes, I think they focus too much on changes in financing policy, often over estimating the tax benefits of debt and under estimating the costs, and not enough on operating changes.

- In short, I would like to see more PE investors live up to the stereotype and not behave like value investors.