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Private equity: Pecuniary logic and enterprise restructuring

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Long ignored outside the financial sector, private equity is now attracting widespread attention. This has been fanned by recent news items concerning some particularly large takeovers by private equity firms and the enormous income and capital gains which can accrue to their managers and principal shareholders, and which enable lifestyles recalling the earlier gilded age of the late-19th-century United States.

Political interest has focused primarily on the loss of jobs in enterprise restructuring following takeovers by private equity firms, and on low rates of taxation of the remuneration of private equity managers and investors. Broader issues are also coming under scrutiny. The International Organization of Securities Commissions (IOSCO), a body which fosters cooperation between different countries' securities markets and regulators, has established a task force to examine the implications of the increased role of private equity firms in global mergers and acquisitions (M&A), where their share of activity is now estimated to be as much as 20 per cent.

The ambitions of private equity firms are increasingly directed at new targets. These include sectors like banking and pharmaceuticals where the value of firms is large and performance is not necessarily crying out for restructuring. Moreover, as part of the globalization of finance, private equity firms are raising their profile in Asia, a development likely to stimulate the growth of an indigenous private equity sector.

Character and history

Private equity is usually understood to cover the provision of medium- and long-term financing to firms not quoted on public stock markets as well as the financing of the equity tranches in buyouts of public companies. Financing in private equity operations is in the form of both equity and debt. The equity is typically provided by private equity funds which raise their capital from funds of funds, pension and investment funds, endowments and rich individuals. The initial debt is provided by banks but typically a substantial share of this debt is subsequently distributed to other financial institutions.

As a financing vehicle, private equity is most important in the United States and the United Kingdom. In both countries private equity shares common historical origins with venture capital financing.

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In the United States, what is now called private equity financing developed features distinguishing it from venture capital in the 1980s. This followed some propitious legislative initiatives such as lower taxes on capital gains, relaxation of the Employee Retirement Income Security Act (ERISA) rules which had previously prevented investment of savings under this heading in high-risk ventures, and reduction in the reporting requirements for firms conducting private equity management.

In the United Kingdom, for the first 30 years after 1945 the most important source of venture capital was the Industrial and Commercial Finance Corporation (ICFC) – later renamed 3i – established by the government in response to the finding of the 1931 Macmillan Committee (of which Keynes was a member) that there was a financing gap for small and medium enterprises (SMEs). Development of the private equity sector as it now exists followed the relaxation in the 1981 Companies Act of restrictions on operations which are typically part of company buyouts, and the creation in 1982 of the Unlisted Securities Market which had less rigorous criteria than the London Stock Exchange for admission and thus facilitated listings for younger companies.

Since the 1980s private equity financing has become increasingly identified with leveraged buyout (LBO) financing. By contrast venture capital financing refers to investments, mainly in the form of equity, made in the start-up or early stages of a firm's existence. LBO firms engage in more complex and often much larger transactions than venture capitalists, and their operations are less dependent on equity financing.

As in the United Kingdom during the early period after World War II, the function of providing finance for start-ups and enterprise restructuring has historically not been limited to venture capital and private equity on the contemporary model. In the United States and the United Kingdom these two vehicles now complement the provision of ongoing lending to firms by commercial banks and specialized financing institutions such as finance houses, and of longer-term financing in the form of debt securities and equity (as well as some forms of direct lending) by investment banks. By contrast, elsewhere long-term financing, including that for start-ups and restructuring, has often been most importantly available from universal banks, which, as their name suggests, provide a more complete range of financial services than commercial banks, and from development and industrial banks, whose lending is explicitly linked to agricultural, rural or industrial development.

Institutions, structures and fees

The institutions which raise money for private equity investment and manage the funds come in a number of sizes and organizational forms. At one end of the spectrum are conglomerate firms with structures consisting of partnerships, corporate entities, or both. These include many of the earlier and best-known firms such as Blackstone (which recently closed to investors the world's largest private equity fund of US$21.7 billion), Kohlberg Kravis & Roberts (KKR) (with a fund still open to investors of US$16.6 billion), Carlyle Partners (with a fund still open of US$15 billion), and Texas Pacific Group (with a closed fund also of US$15 billion).[1]

These conglomerate firms have been responsible for the industry's largest transactions. For a long time first place in this list belonged to the buyout by KKR in 1988 of the food and tobacco company RJR Nabisco for US$30.2 billion. But in 2007 this deal has been exceeded by the announced but – at the time of writing – not-yet-completed acquisition of the Texas utility TXU for US$44.3 billion by KKR and the Texas Pacific Group, the acquisition of Equity Office Properties for US$37.7 billion by Blackstone, and that of HCA hospitals for US$32.2 billion by KKR and Bain Capital.

In the firms are to be found not only the industry's best-known partners and managers but also other figures with high public profiles. Carlyle is particularly notable on this front. Founded in 1987 and initially distinguishing itself with investments in ailing airlines and companies hit by reductions in the Pentagon budget, Carlyle has included amongst its senior managers, advisers and partners James Baker, former United States Secretary of State, Frank Carlucci, former United States Secretary of Defence, George Bush senior, John Major, and Lou Gerstner, former chairman of IBM.

Elsewhere in the spectrum of private equity firms there are affiliates of banks – of which the largest private equity fund, at US$20 billion, is that of GS (Goldman Sachs) Partners – offshoots of institutional investors such as insurance companies and asset managers, corporations with investments in start-up ventures in their own industries, and syndicates of wealthy individuals.

Private equity firms, which usually have small staffs, rely on outside advisers and asset managers for assistance in identifying potential investments and for executing transactions. Under this heading they generate substantial revenues for investment banks (8 per cent of their global revenues in 2006) and for the corporate finance groups of accounting firms.

The structures chosen for private equity groups (funds, managers and investors) vary. They depend on the benefits and burdens of different legal and tax regimes, and include a number of onshore and offshore partnerships, investment trusts, and corporate vehicles.

At the core of a structure commonly chosen for larger private equity firms and funds in the United Kingdom is a set of partnerships. One of these is a General Partner, responsible for management, with unlimited liability. The General Partner may be independent or, alternatively, linked to another bank or institutional investor. The partnerships with limited liability take no part in management, their role being restricted to investment. Investors in a fund may number more than 100 but are still few in comparison with those in a traditional investment fund. A limited partnership is usually also set up as a "carry" vehicle which receives remuneration in the form of "carry interest" for the executives.

The fee structure in private equity includes a number of different components. A priority share of profits of 1-2 per cent of capital is paid to the General Partner during the early years of investments, and a lower percentage subsequently. Transaction fees may be paid to managers for the identification and completion of transactions. "Carried interest" is a performance fee paid to managers. This is typically not paid until capital has been returned to, and a hurdle rate of return has been achieved for, investors through the limited partnerships. "Carried interest" is typically about 20 per cent of capital gains but may be higher (as much as 40 per cent) once the other obligations have been met. This may represent a very high rate of return on a manager's investment which is often only a small percentage of the firm's total investment (and of which a significant share may have been borrowed).

Taxation

Devices which enable private equity structures to pay tax at low rates have recently attracted special scrutiny in the United States and the United Kingdom. These devices take full advantage of different private equity structures, the possibilities of reducing taxes by shifting the recording of taxable income and capital gains as between different points of time and different parts of the firm, and the use of tax havens.

In the United States Congress special attention has focused on the treatment of the earnings of private equity managers as capital gains rather than income, which is subject to a higher rate of tax. To its critics this practice is anomalous for remuneration which should be classified as performance fees. At the time of writing, the practice is the target of bills introduced in the Senate by the Democratic Senator Max Baucus and the Republican Senator Charles Grassley, and in the House of Representatives by a number of Democrats.

The proposal of the latter would redefine much of the partnership income currently taxed at the rate applying to long-term capital gains as income accruing to a newly defined class, "investment services partnership (ISP) interests". This would be treated as ordinary income for tax purposes.

In the United Kingdom the fiscal justice of current rules for private equity was recently queried by Nicholas Ferguson, a leading figure of the sector, who pointed out that a cleaning lady or low-paid worker could pay tax at a higher rate than a private equity executive. The main focus of criticism here is the taxation of "carried interest" as capital gains on the basis of a 2003 memorandum of understanding between the industry and the tax authorities. The capital gains can then benefit from tax rules designed to encourage business start-ups. These rules take the form of "taper relief" which limits to 25 per cent the capital gains chargeable to tax on certain assets held for at least two years, thus lowering the effective rate of tax from 40 to 10 per cent. [2] Other tax rules favouring private equity apply to exchange-traded Venture Capital Trusts invested in private equity funds which provide tax relief on the initial investment, dividends and capital gains.

Buyouts, restructuring and exiting

The stages of typical private equity operations start with the initial buyout, which may entail taking an exchange-traded company completely private, followed by the restructuring of its operations and balance sheet. Eventual exiting by the private equity investors takes place through sale of the restructured company or other options.

As part of the decision to purchase a target enterprise, the private equity firm looks at the usual factors which influence investments such as the macroeconomic, political, commercial, legal and regulatory environments in which the enterprise operates, and its actual and potential competitive position. The existing management team will be scrutinized to see whether it should be partially or wholly replaced. Special attention will be paid to financial conditions since the costs of different forms of debt and equity capital as well as ongoing levels of M&A activity determine the price at which the enterprise can be acquired as well as the cost of financing the purchase and of subsequent restructuring of the enterprise's balance sheet. Low interest rates in major financial markets have in this way contributed to the recent boom in private equity deals, and tighter credit conditions would lead to a contraction.

The target enterprise's cash flow (typically measured as earnings before interest, taxes, depreciation and amortization) will be attributed a key role in the decision since it determines the enterprise's ability to service debt, including the additional debt incurred as part of the restructuring of its balance sheet by the private equity firm. Debt structures in private equity deals have become increasingly complex, reflecting the possibilities provided by instruments such as non-amortizing ("bullet") debt to adjust or postpone payments obligations. Higher levels of debt and complex debt structures make possible higher leverage and thus higher returns to shareholders, i.e., the managers and investors of the private equity group.

Private equity investors expect eventually to exit from their investments. The period of their commitment varies but an important influence is the time period, typically about 10 years, of the funds involved.

The main options for exiting are an initial public offering (IPO, i.e., flotation of the enterprise on the stock market), a trade sale (to another corporation), or a secondary sale (to another private equity group or financial institution). Alternatively the option chosen may be to retain the investment but after paying off or reorganizing the debt on the firm's balance sheet, or to break up the firm and sell some or all of the component parts separately.

As with the initial purchase and financing decision, conditions in financial markets will exercise an important influence on the terms of exiting. A booming stock market will make flotation attractive, and low interest rates will facilitate trade sales.

Recent IPOs of private equity groups

Blackstone recently launched an IPO of shares in the firm. KKR has announced its intention to follow suit. In the case of the Blackstone issue China surprised financial markets with the announcement that it would invest US$3 billion of its foreign exchange reserves in a 10-per-cent non-voting stake.

On the face of it, these IPOs seem to conflict with the rationale of the private equity groups' own operations, which often involve taking publicly listed firms private (see below). The operations of both Blackstone and KKR are in fact diversified and not limited to private equity. Nevertheless, the IPOs contribute to the blurring of the distinction between different categories of investment management firm.

Commentators have focused principally on the monetary benefits of the IPOs to the founder owner/managers of these operations ("cashing in their chips"). But the moves may also be designed to reduce the private equity groups' dependence on a limited range of institutional investors at a time when the market for credit is showing signs of tightening and the current boom in private equity investment of peaking. Furthermore they may constitute part of a succession policy designed to assure the continuation of the groups in question after the founders' eventual withdrawal from management and control.

Financial regulation and risks

Regulation of private equity groups does not follow a uniform pattern. Indeed, "private equity" is unlikely to be defined as such in a country's regulatory regime. Within the group, activities and constituent entities (fund management and the funds themselves) are likely to be subject to regulation, though this will not necessarily be as comprehensive or stringent as for traditional investment funds (as illustrated by the exemption of the managers of private equity funds from reporting requirements in the United States). Much of the information available to regulators concerning subjects such as leverage, group strategies, and investors in private equity is obtained through supervision of creditors (banks) and of the pension funds which invest in the sector.

As the share of industry in European countries controlled by private equity groups has increased, so have demands for reducing the opaqueness of their operations. These demands concern each of the major parties, namely the firms in private equity portfolios whose private status exempts them from reporting requirements applying to exchange-traded institutions, the limited partnership funds, and the General Partners or investment managers. Regulatory change would be likely to require concerted action by European governments to avoid regime shopping by private equity groups. A proposal for voluntary acceptance of greater transparency by private equity groups has recently been made in a report by the United Kingdom banker, Sir David Walker.

The prevailing view amongst European regulators is that banks are not currently threatened by the levels of leverage, i.e., of debt in relation to equity financing, of the private equity groups to which they are exposed as creditors. This view is based not only on the relevant numbers but also on features of the private equity sector such as low levels of leverage of the limited partnership funds. Regulators are nonetheless following closely the effects which competition in the sector is exerting on leverage as part of the search for higher returns.[3]

This sanguine view amongst regulators is tempered by unease due to uncertainty about the ultimate ownership of economic risk in debt markets and knock-on effects of problems in parts of the financial markets. This unease has been expressed by Jean-Claude Trichet, President of the European Central Bank, as follows: "The state of the fundamentals in the credit markets, CRT [credit risk transfer] and unregulated financial institutions can together be described as a potential 'triangle of vulnerability' in that a shock at any corner of this triangle could have implications for the other two. For instance, a significant turn in the credit cycle could mean that credit protection-sellers, such as hedge funds, could become unable to make due payments to banks. Similarly, if widespread problems were to emerge at hedge funds or private equity funds which are active in CRT markets, this could even spark a downturn in the credit cycle."[4]

Benefits of private equity

The benefits attributed by its apologists to private equity consist primarily of restructuring of firms with favourable long-term effects on employment, and of improved returns to shareholders. Taking firms private through buyouts, it is maintained, facilitates the achievement of these objectives.

The many financial and other reporting requirements and disclosures to which United States and United Kingdom listed companies are subject, especially the quarterly reporting of earnings, have long been viewed as the root of undesirable short-termism in the setting of listed companies' goals. This has sometimes even resulted in the use by listed companies of accounting-driven transactions to boost their quarterly results. The short-term demands for dividends by investors in publicly traded equities are frequently incompatible with the longer investment lead times of certain businesses in their start-up and development phases. More generally, private equity investment vehicles serve as a means of raising capital for businesses which require development strategies involving periods during which investors and management are prepared to forego dividends and high remuneration.

Private equity operations have also been used to facilitate the succession of family-owned businesses between generations of owners when successors are unready or unable to take charge of the business during a limited period. In such cases private equity groups have stepped in and taken over the ownership and management during the period of transition between generations, providing family members with the option to repurchase the business when they are ready to assume their role as owners.

As with M&A activity more generally, the actual record of private equity investments is mixed.

Concerning the role of private equity between the 1980s and the mid-1990s in the United Kingdom, the author of one of the few systematic treatises on private equity has expressed the view that "it is no exaggeration to say that the private equity revolution has played a key role in the dismantling and reassembling of Britain's industrial base in the course of the 1980s and in the creation of the UK's new service-orientated economy".[5]

The success stories of this process involved businesses in several different activities including food, engineering, newspapers, garden equipment, railway carriages, and public houses. In addition to cash flow capable of supporting additional debt, characteristics of firms conducive to the eventual success of private equity investment included a diversified customer base, an actually or potentially strong market position, and an easily understood product. Less successful cases and failures included retailing and consumer products.

In the United States KKR sold off over a number of years its interest in RJR Nabisco, the target of its celebrated 1988 buyout, at a rate of return widely considered not to have matched the risks involved. Studies of the impact of the country's LBOs on employment, research and development, and capital spending indicate an uneven record. The sometimes precarious position of firms involved in LBOs was highlighted by the sequel of a 1989 study by KKR itself, which included 13 firms from its own portfolio in its sample, and which unsurprisingly highlighted LBOs' benefits. Shortly after the release of the study, some of these firms defaulted on their LBO debt.

Conflicts of interest and market abuse

Private equity provides many opportunities for conflicts of interest. Some of these are similar to those found in other forms of fund management, such as potential conflicts between the manager's (General Partner's) responsibilities to itself (owners and staff) and to investors in the funds managed by the group. Others are more specific to private equity. These include conflicts between the interests of General Partners and investors in the group, on the one hand, and of firms in their portfolios, on the other. The multiple roles of banks vis-à-vis private equity, as creditors and as advisers to different parties to deals, are also a potential source of conflicts of interest.

In the United States there has been special attention to conflicts of interest in management buyouts (MBOs). Managers are expected to maximize the value of shareholders' investment in their company but this role may conflict with their own interests when they make an offer to the same shareholders to buy the company.

During the LBO boom of the 1980s in the United States there was extensive recourse to junk bonds (low-rated debt securities) as part of the use of increased leverage during company restructurings. Here the potential conflict of interest was between the managers responsible for the LBO and the holders of the junk bonds, on the one hand, and holders of the pre-LBO bonds whose value was likely to decrease in response to the greater risk in the company's balance sheet due to post-LBO restructuring, on the other.

The influence in practice of several of these potential conflicts of interest is difficult to gauge. But the dangers are considered sufficiently important by the United Kingdom Financial Services Authority (FSA) to be the subject of frequent communications with banks and private equity groups.

The flows of price-sensitive information within private equity groups, between different groups, and between groups and banks create the potential for market abuse in the form of insider transactions. Such flows of price-sensitive information are not peculiar to participants in private equity operations. Similar concerns have frequently been raised in connection with hedge funds.

About a quarter of recent price-sensitive announcements by firms are estimated by the FSA to have been preceded by movements in share prices suggesting insider trading, and a similar survey in New York (conducted by the *New York Times*) found a figure of about 40 per cent. The FSA has rated favourably the controls on leaks of price-sensitive information in the larger private equity firms but clearly remains concerned about the scale of the continuing potential for such leaks, given the industry's structure.

Primacy for pecuniary logic

Attempts to weigh the catalyst role of private equity in industrial restructuring against the associated financial engineering and cost cutting, which are often of more dubious value and driven by stark pursuit of the profit motive, lead naturally to more general questions. Deserving special attention here are the assumptions about corporate governance associated with the private equity model and the appropriateness of private equity as a financing vehicle in countries at different levels of development.

In a recent editorial the *Financial Times* opined that the globalization of finance, of which private equity has become an important part, has the effect of establishing "the globalization of maximization of shareholder value" as the pre-eminent standard of corporate governance. However, as the *Financial Times* also noted, this process is not without dangers to the financial sector itself, since its continuation will depend on its compatibility with perceptions of fair treatment on the part of citizens in democratic nation states. This compatibility in turn is likely to require a framework of global regulation which includes cooperation among national fiscal authorities.[6] The main set of internationally agreed standards for corporate governance is the OECD Principles of Corporate Governance. Originally endorsed in 1999, the Principles are included in 12 financial standards identified as essential to the soundness and stability of financial systems and as having a key role in measures to strengthen the so-called international financial architecture. Observance of these standards is now a subject covered by the Financial Sector Appraisal Programme (FSAP) of the International Monetary Fund (IMF) and the World Bank.

While devoting considerable space to shareholders' rights, the OECD Principles also include as one of six basic standards the recognition, and protection of the exercise, of the rights of an enterprise's other "stakeholders", a somewhat imprecise term which covers employees and suppliers as well as investors and creditors. In the preamble the Principles state that there is no single model of good corporate governance, and no attempt is made in the Principles to weight the relative importance of the interests of shareholders and other stakeholders. But the Principles could not be interpreted as attributing an importance to the interests of shareholders which overrides other considerations.

Emerging markets and other developing countries

Although the bulk of private equity investment is still in industrial countries, private equity groups are showing increasing interest in opportunities in the developing world. Unsurprisingly the main focus of attention is Asia, where emerging markets accounted for a significant proportion of buyouts by private equity groups outside Japan which amounted to US$33 billion in 2006. There has also been private equity investment on a smaller scale not only in Latin America but also in Africa (for which several funds attracted by investment prospects in natural resources and infrastructure have recently been announced).

In developing regions private equity deals are typically smaller than in industrialized countries, investments in African countries often amounting to just a few million dollars. Moreover the distinction between private equity, on the one hand, and venture capital and finance for SMEs more generally, on the other, is less clear-cut. Investments in private equity funds in developing countries often include local partners and multilateral development finance organizations such as the World Bank.

Private equity transactions in developing countries must be compatible not only with local rules applying to different kinds of financing and financial institutions but also with the regimes for foreign direct investment (FDI) and other private equity investment. These regimes frequently prescribe the permissible proportions of foreign ownership of domestic companies to percentages well short of full ownership and thus prevent the 100-per-cent buyouts characteristic of much private equity investment in major industrial countries. The scope for private equity investment is also likely to be reduced in Asian countries by family ownership of major firms. The level of development of local financial markets can be expected to weigh heavily in a private equity group's decision concerning an investment in an emerging market since it will have a major influence on the terms of eventual exiting in the form of the price realized through an IPO or trade sale.

Controls over and careful vetting of inflows of private equity investment are appropriate in developing countries. They reduce the scope for exploitation by private equity groups of the underpricing of the stock of companies due to the underdeveloped state of local financial markets as well as of other anomalies in these markets due to weaknesses in supervisory or accounting regimes. Moroever they make possible checking of private equity investments for their consistency with national industrial or development policy.

The conflicts to which private equity investment can give rise are exemplified by recent controversy in South Korea over the investment of Lone Star, a United States private equity firm, in the Korea Exchange Bank (KEB). Here the issues were whether Lone Star was involved in the manipulation of KEB's financial data in order to reduce its price (a charge of which it has been cleared by local prosecutors), and whether Lone Star was a "financial" firm, in the absence of which qualification it did not have the right to a stake exceeding 4 per cent of a Korean financial firm.

There are several indications of Asian countries' interest in the development of their own indigenous private equity sectors. South Korea already has such a sector. China has recently made changes to its legal framework expected to boost the development of local private equity groups. India, recipient of the largest inflow of private equity investment amongst developing Asian economies so far in 2007, may well follow suit. Indigenous private equity groups from these countries are unlikely to limit their ambitions to their local markets.

Future cross-border investment of private equity groups of both industrial and emerging-market countries is likely to take place in an environment of tighter control of both FDI and foreign portfolio equity investment. Until recently pressure for changes in foreign investment regimes came mostly from industrial countries and targeted restrictions in emerging markets and other developing countries.

This now seems to be changing, with new restrictions under consideration in industrial countries. A source of concern in these countries is the huge resources (as much as US$2,500 billion) potentially at the disposal of sovereign wealth funds controlled by the state in China, Russia and the Middle East. Large investments by such funds, it is argued, could lead to distortions in the economic behaviour of recipient firms in industrial countries and to forms of dependence capable of exerting unwanted pressures on national policies. In the United States takeovers by foreign companies will also face tighter scrutiny owing to new rules designed to avoid the transfer of sensitive technologies and to maintain national control over the management of infrastructure such as ports.

The more restrictive regimes for foreign investment likely to issue from the changed climate are not directed at private equity as such. Nevertheless, more restrictive regimes in industrial countries are not likely to be accompanied by substantial additional liberalization of features of the regimes in emerging markets which currently limit the growth of investment by foreign private equity groups. Eventual access to markets in industrial countries for private equity groups from emerging markets may thus become more difficult, with the result that the cross-border ambitions of these groups may focus to a greater extent on opportunities in other developing countries.

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Endnotes

1. See "Private Equity", *Financial Times Special Report*, 24 April 2007, and J. Politi, F. Guerrera and M. Mackenzie, "Blackstone closes world's largest private equity fund at $21.7 billion", *Financial Times*, 9 August 2007.

2. Under the reform of capital gains tax recently announced in the 2007 Pre-Budget Report and Comprehensive Spending Review, a single tax rate of 18 per cent is to be introduced and taper relief abolished from April 2008.

3. European Central Bank, "Large Banks and Private Equity-Sponsored Leveraged Buyouts in the EU", April 2007, and Financial Services Authority, "Private equity: a discussion of risk and regulatory engagement", Discussion Paper 06/6, November 2006, Chapters 3 and 4.

4. Intervention by Jean-Claude Trichet at the International Monetary Conference Central Bankers Panel, Frankfurt am Main, 5 June 2007.

5. Peter Temple, *Private Equity: Examining the New Conglomerates of European Business*, John Wiley, 1999, p. 8.

6. "Why finance will not be unfettered", *Financial Times*, 25 June 2007.