

Times MBA Podcasts Week 3 - Tim Jenkinson: Private Equity - New Kings of Capitalism?

Hello, I'm Tim Jenkinson. I'm a professor of finance at the Saïd Business School at Oxford University. This podcast is about private equity, which is what I teach at Oxford and the subject of much of my research.

Although increasingly important in all the major economies, private equity is a sector that many people still know little about. This is not surprising. The amount of public information about the transactions, the performance and the activities of the private equity funds is limited. But the amount of money raised by private equity funds over the last few years has been enormous. In 2006 alone, more than US\$ 400 billion was raised by private equity funds and for reasons I'll explain, their buying power is two or three times higher than this figure. Private equity funds are increasingly looking at large companies, many of them publicly quoted, as potential take over targets. The way private equity firms manage funds differs significantly from the traditional public company model and has led some to question whether private equity is a new and superior form of corporate governance.

This podcast will lift the veil on the private equity sector and look at whether those who work in private equity are really the new kings of capitalism. But I am going to start right at the beginning and explain what is meant by private equity and how it contrasts with conventional finance. Next, I'll explain how the funds are organised and where the money flows from and to. Then I will look at the performance of private equity funds over the last few years. Finally, I will talk about what private equity firms actually do to the companies they invest in or acquire and how they may add value.

All around us are companies that were created with the help of private equity or are currently owned by private equity funds. Technology companies like Google or Cambridge Silicon Radio; retail groups such as Toys 'R' Us or Debenhams; service companies such as the AA or Hertz; media assets such as Metro-Goldwyn-Mayer or the Times Educational Supplement, have all been, or still are, owned by private equity. There are few sectors that have not attracted the attention of private equity funds, from infrastructure such as airports or water companies to cinemas, from satellites to sports rights, from hospitals to car parks. There are few mergers or takeovers these days that do not excite the interest of private equity.

But let's start right at the beginning and define what I mean by private equity. Definitions differ but when I talk about private equity I mean the entire asset class of equity investments that are not quoted on stock markets. So, the private equity class stretches from venture capital, working with really early-stage companies that in many cases will have no revenues but potentially good ideas or technology, right the way through to large buyouts where the private equity firm buys the whole company. In some cases these companies might themselves be quoted on the stock market

and the private equity fund performs a so-called public to private transaction, thereby removing the entire company from the stock market. But in the majority of cases, the buyout transactions will involve privately owned companies, sometimes with family ownership or, very often, a particular division of an existing company. In between these two extremes are other forms of later-stage financing such as providing capital to back the expansion of existing businesses. But for the most part, I'll refer simply to "venture capital" and "buyouts" as the two main forms of private equity.

How is the invested money split between venture capital and buyout deals? Well, in broad terms, around four-fifths of the money has been flowing into buyouts in recent years, on both the US and Europe. In part, this is due to the sheer scale of buyouts where an individual deal can absorb several billion dollars of capital. In contrast, venture capital deals tend to drip feed money into companies as they develop. But it is also because investors have increasingly been focussing on buyout firms, especially in Europe as the average returns earned have tended to be higher. More on this later.

So, where does the money come from and who runs the private equity funds? Most of the money comes from institutional investors such as pension funds, endowments and insurance companies, although many high net-worth individuals also invest directly or through fund of funds intermediaries who provide them with a more diversified portfolio of investments. At present, the proportion of assets allocated to private equity is considerably higher in the US than in Europe, although all surveys of European investors tend to find that the fund managers are aiming to increase their allocation to private equity. So, the flow of money is likely to continue and, indeed, grow.

What about the funds themselves? Well, there are all sorts of different players in this market. Most of the pure private equity funds are structured as limited partnerships. This isn't the time to go into fine legal distinctions, but, essentially, they are tax-efficient investment vehicles which have a limited duration, almost always with a ten-year life. Investors commit a certain amount of money to a fund. The fund then asks the investors to actually send the money only as they find investment opportunities. These calls for capital take place over the first few years of the ten-year life of the fund.

Now, a critical aspect of private equity funds is that they are not investors who buy to own the companies for the long term, they are buy-to-sell investors. They want to make their investments, create value and then exit. They are judged on two measures of performance. The main one is simple cash-on-cash returns. Whatever sums they commit, the investors care about how much they get out, net of all the payments to the fund. A good investment might return three, four or even higher multiples of the original sum invested. Alternatively, the investment may disappoint and return a fraction of the original sum, or in many cases, particularly with venture capital, be worthless after a few years.

The second performance measure is the internal rate of return that investors achieve which depends on how long it takes for the investors to get their money back. So a profit achieved in two years will have a higher internal rate of return than if the same profit took four years to achieve. Given these performance measures, a private equity firm has sharp incentives to create value, to exit the investments and return the money to the investors; the partnership agreements do not let them reinvest the proceeds in the next available opportunity. These are not like mutual funds who shuffle their holdings and only return the money if investors ask for it. Funds have to go out and raise capital again by launching a new fund. If performance has been

poor this won't be easy. So, most funds, but not all, are organised as limited partnerships.

The other aspect of these funds that I want to highlight is the remuneration of the private equity firm who are the so-called general partners of the partnership. There are two components to this remuneration. A percentage fee for managing the fund, which is often 2% per annum; it could be higher for successful venture capital firms reflecting their general smaller size and might be lower for the much larger buyout funds. This fund is typically paid on the capital committed, not the amount invested, at any one time. So, over the ten-year life of a US\$ 1 billion fund, the management fees might sum to US\$ 200 million and some funds find, in my view, questionable ways of increasing this income even more by charging transaction fees to the companies they acquire or by levying ongoing management charges. These annual fees and additional charges can yield very large sums of money especially when one considers that the funds are extremely lean organisations with few employees and even fewer partners who enjoy a share of the profits.

This profit share is the second part of the remuneration and is referred in the private equity world as carried interest. The carried interest is typically set at 20% of the net profits earned by investors and is only payable when the investment is realised and the cash has flowed back to investors. So, if a US\$ 1 billion fund returns US\$ 3 billion to its investors, the profit would be US\$ 2 billion dollars and the lucky few in the private equity fund who enjoy a share of the carried interest, would share 20% of this, that is, US\$ 400 million. Perhaps now you start to understand why private equity is the hottest job on the block for business school students. Investment banking or strategic consulting are good but the real kudos goes to those who make it through the doors of private equity funds or their cousin in the alternative asset space, the hedge funds.

Although private equity and hedge funds share this so-called 2 and 20 remuneration structure, the key difference is that private equity professionals only get their profit share once the fund is substantially realised, which might take up to the full 10 years. This means that there is little turnover in the top ranks of private equity funds as the partners wait for their carried interest to vest. Profits flow to hedge fund managers on an annual basis but that's another story.

One final word on the funds and recent trends. The last year or so has seen the size of the funds focussed on buyouts growing to enormous proportions. There are now several funds in the US and Europe which have around US\$ 15 billion of committed capital. Do the simple maths on these funds. Annual fees each year of 2% generate an income of around US\$ 300 million a year and then a good, but hardly exceptional, doubling of the investor's money would result in carried interest payments of US\$ 3 billion at the end of the fund. And how many people might share these profits? Maybe 10 to 20 people taking home a few hundred million dollars each. Life in the top funds can be good.

An important implication of the growth in the size of funds is that larger and larger companies are becoming potential targets for private equity funds. Until recently, the largest deal involving private equity remained the famous buyout of RJR Nabisco by the private equity firm, Kohlberg Kravis Roberts, in 1989 which was valued at around US\$ 30 billion. But 2006 saw a few larger deals take place. I confidently expect many more mega-deals in the future, often involving stock market listed companies with several private equity firms investing together. There really are few public companies that can feel insulated from the attentions of private equity funds and the

number is shrinking each year. So, lots of money is flowing into private equity. Funds are getting bigger and deals are getting larger and more high profile.

But what of the returns? Has private equity been a good investment? The answer is perhaps surprising. However, before I tell you the answer I need to inject a word of caution. Any analysis of performance faces a significant problem which is that while private equity funds have an obligation to report regularly and in detail to their investors, there is absolutely no obligation to make this return information public and some funds go to considerable lengths to maintain such secrecy, despite the efforts of certain parties such as journalists and academic researchers.

In my view, there is no good reason to maintain such high levels of secrecy especially once funds have essentially exited their investments. Sooner or later, I suspect, the calls for greater disclosure will be heeded. Anyway, the implication is that evidence on returns is partial at best and is very likely to suffer from what is known as selection bias. Why? Because funds are more likely to reveal their returns to various parties who report and who usually sell such information if they have been impressive. The peaches are far more likely to be reported than the dogs. This is an important caveat to remember when you see evidence quoted on average realised returns to private equity.

Anyway, even though the evidence is incomplete and probably biased in an upward direction, what does it show? Well, looking at the European market over the last 25 years, it shows that returns have, on average, been unremarkable and in some cases, downright disappointing. These disappointments have been greatest at the early stage venture capital investing where on average investors have barely received their original investments back. And note, this just measures cash returns; there is no allowance for inflation or the opportunity cost of not investing in the stock market, or even leaving the cash in the bank earning interest.

But this average hides the real story which is that funds differ hugely in their performance and we're not just talking a couple of percentage points, as would be the case with traditional unit trusts or mutual funds. Let's stack up the funds in terms of their returns and look at **the** fund which would be ranked at the 25th percentile - very good performance but not some extreme outlier. Within Europe, the internal rate of return on this fund has, on average, been 20 percentage points higher than the corresponding fund that would be ranked at the 75th percentile. Put another way, the latter fund, which is just in the bottom quartile of the distribution, might return a negative internal rate of return of 8%, whereas the former fund, which is just in the top quartile, has returned around +12%. Furthermore, there is growing evidence that superior performance by particular private equity firms is persistent over time as they raise new funds. So, if you were investing in private equity, manager selection is everything. But the funds run by successful managers are often hugely over-subscribed, so it can be difficult for investors new to private equity to obtain access.

There is one other problem that investors face. Because it's difficult to get consistent and complete information on the performance of past funds, it's difficult to know which private equity firms have actually performed well. There is a joke in the industry that all private equity firms are in the top quartile and on some particular and selective measure that may be the case. For instance, I've seen claims of the form, "Our funds have achieved top quartile performance" then a footnote saying, "In comparison to all French funds raised from 95 to 98 investing in buyouts in Europe valued between 500 and 700 million euros". An exaggeration, perhaps, but not an extravagant one. And there are plenty of other tricks. Internal rates of return can be worked out in a variety of ways and funds can pick the most favourable way. And

investments that have not been realised have to be valued and funds can keep them on the books at generous prices so as to boost the apparent return of the existing fund. I'm not saying that all funds do this but the point is that in contrast to public equity investment there's a lack of transparency and consistency which, as the private equity sector grows, is, I believe, increasingly problematic.

Anyway, leaving aside the problems of measuring returns, things look a lot brighter when looking back at the returns earned by buyout funds. For instance, in Europe over the last 25 years, the average returns have been around 10% per annum. The average return of the top quartile funds has been nearly 30% per annum. Put another way, investors in these top quartile buyout funds have received back double their money and these excellent returns have been even more pronounced for the buyout funds that focus on very large transactions. The prospect of these sorts of returns explains why investors are putting more and more of their portfolios into private equity. But as you might expect from what I have said so far, in recent years the flow has predominantly been into buyouts rather than venture capital.

Okay, so far the story is that the best private equity firms can produce excellent returns; whether you can spot them up front or get access to them as an investor is a different matter. But how do they add value? Again, the story is different in venture capital and buyouts. In a typical early-stage company, the venture capitalist is working closely with the entrepreneur providing not just finance but also mentoring, access to networks, business disciplines, support services and so on. Capital will typically be allocated in tranches and only released if certain milestones or targets are met. So a firm might be given £1 million to develop a prototype and only be given additional funding if this is successfully achieved. The venture capitalists typically sit on the boards of directors and although not often in overall control, would have considerable influence over the company, its strategy and the entrepreneurs. For this the venture capitalists often need industry-specific knowledge; in part to shape the strategy of the firm but also because their networks can enable collaboration with potential suppliers or complementary firms, which can be critical to success. Many early ventures fail but the returns are really driven by the home runs, the firms that return 50, 100 or even 1,000 times the original investment. Spotting these from an early stage is a very valuable and rare skill, although luck can also play its part.

With buyouts the game is really very different. Buyout funds are looking for existing companies where they could create value. Invariably, the funds buy the companies only partially with their own money and raise the balance as debt finance. This debt finance is initially raised by banks but only a fraction would actually continue to be held by banks. Increasingly the debt gets repackaged in the form of complex financial instruments, such as collateralised loan obligations, or is held by investors such as hedge funds. Again, that's a different story.

In a typical buyout deal, the private equity fund puts in about a third of the money and the remaining two-thirds is debt finance. This is why they are often referred to as leveraged buyouts. At this stage people often start seeing images of asset-stripping, swashbuckling capitalists such as Gordon Gekko in the film *Wall Street*; financiers who have no intention to run the business but to buy companies using other people's money, sell off some parts, shut down others, sack plenty of workers and end up with a lot of cash at the end. This is not the way it typically works.

The successful buyout firms aim to grow a business, to provide clear strategic direction and prepare it to be sold to a new owner within a few years. As I said at the start, these are buy-to-sell investors, not buy-to-own and the only way to increase the

value of the firm is to make it more efficient and competitive; and they're impatient - they want to achieve results quickly, not over decades. Only when they exit do the profit shares flow. So they typically take full control of the company. Unlike in stock market quoted companies where shareholders play only a limited role in the governance and decision-making of the firm, private equity owners are in control and define a clear strategy for the firm. They set tough but realistic targets and keep management focused on them. They establish extremely sharp incentives on management in the form of financial returns if they are successful and they recruit the best talent to execute their vision. It's really a different form of corporate governance. Rather than being required to publish quarterly results which are then gone over with a fine toothcomb by analysts, rating agencies and the media, and to generate nice steady profit and dividend growth for investors with no surprises, managers of private equity firms can operate outside the public arena. They are owned by one or sometimes a few private equity funds that set very clear objectives which might well involve a radically different strategy. In the case of a public company it could be difficult or, indeed, dangerous in terms of alerting competitors, to explain such strategic shifts to all shareholders through public statements. So, radical and quick transformation is difficult. Private equity ownership is highly concentrated and is not divorced from control. Incentives are sharp on all sides. Indeed, the financing of the buyouts by debt significantly increases the risk/reward ratio for all sides as is predicted by standard financial theory. Having to pay the interest on the debt focuses attention squarely on cash flow, which can have a tremendous discipline on management, and by using significant amounts of debt, the private equity funds have to put up less cash to acquire ownership. The same goes for management who would be expected to put in a significant amount of their own money to buy an equity stake in the company. If the deal works and the debt is successfully paid off the returns to the equity holders can be spectacular. The private equity fund can realise several multiples of its original investment and management may receive 10s or sometimes even 100s of millions of pounds. Everyone is happy.

But could this happen in a publicly quoted company? Would investors be prepared for a successful chief executive to walk away with £100 million? Or would he/she and their family have to endure the media spotlight and headlines about "fat cats" or the sight of inflatable overweight pigs flying in the air? Is it any wonder that surveys of leading executives increasingly find that private equity-controlled companies are where people want to work? This is why I say that private equity is really a different form of governance which is challenging the dominance of stock-market-quoted companies.

But I don't want to give the impression that one form of governance is necessarily superior at all times, for all companies. For some firms life on the stock market may be fine. Strategic direction is well-defined, the board of directors functions well, capital structure is efficient, incentives are aligned and investors value the firm appropriately. It is not clear in such a case what value private equity would add. But for companies that are underachieving or have neglected all non-core parts of the business, or where the management is not delivering, or where governance is ineffective, private equity can provide rapid and fundamental change. The focus on value creation and the buy-to-sell approach can produce some spectacular returns for investors.

So, are those that work in private equity, the new kings of capitalism? Some are certainly paid royally, although success is far from guaranteed. History is littered with unsuccessful one-fund wonders or previously successful firms that have lost their way. It's worth remembering the riches do not just fall from heaven. The successful private equity firms employ some of the best talent around. This new model in

approach to governance and value creation is certainly shaking up the thinking of all companies, few of which can feel immune to the reach of private equity. It's not quite a revolution but it certainly is a challenge to the throne.