How private equity firms are designed to earn big while risking little of their own

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Private equity firms are financial actors that sponsor investment funds that raise billions of dollars each year. The funds typically buy out high-performing companies using high amounts of debt and plan to resell them in a five-year window – promising investors outsized returns in the process. They propose to do this through a combination of operational improvements and financial engineering techniques that extract resources from companies, often leaving them financially vulnerable.

This business model, known as a 'leveraged buyout', was widely used and then discredited in the 1980s; but it returned under the guise of 'private equity' and has grown dramatically in the last fifteen years – both in the US and in Europe. Between 2000 and 2012, private equity firms invested $3.4 trillion in some 18,300 buyouts of U.S. companies. And while PE investments fell sharply in the great recession, they largely recovered thereafter.

More than other types of financial intermediaries, private equity (PE) takes an *active* role in managing the companies it buys. Before a company is purchased, the fund's general partner (who makes all decisions for the PE fund) develops a plan for how much debt to use, how the company's cash flow will be used to service the debt, and how the PE firm will exit the company at a profit. The limited partners in the fund put up 98 per cent of the fund's equity while the PE firm and its general partners put up 2 per cent or less. Pension funds account for 35 per cent of all investments in PE funds — creating a moral dilemma for workers whose retirement savings may be putting other companies and workers at risk.

In our book, we illustrate the many ways that private equity firms make money and the effect they have on the lives of working people. Sometimes private equity *does* perform as advertised – using reasonable amounts of debt and providing access to management expertise and financial resources. This usually involves small companies — with few assets that can be mortgaged, but many opportunities for operational improvements. Most PE investments, however, are in larger companies that already have modern management systems in place and also have substantial assets that can be mortgaged. Here, private equity firms use debt and financial engineering strategies to extract resources from healthy companies.

How do private equity firms make money?

Leverage is at the core of the private equity business model. Debt multiplies returns on investment and the interest on the debt can be deducted from taxes. PE partners typically finance the buyout of a company with 30 per cent equity and 70 per cent debt. Private equity funds use the assets of the acquired company as collateral and put the burden of repayment on the company itself. The PE firm has very little of its own money at risk – PE partners invest 1 to 2 per cent of the purchase price of acquired companies (2 per cent of 30 per cent is .02*.3 = .006 or 0.6 per cent). Yet they claim 20 per cent of any gains from the subsequent sale of these companies.

PE firms play with other people's money – from investors in its funds to creditors who provide loans. Leverage magnifies investment returns in good times – and PE firms collect a disproportionate share of these gains. But if the debt cannot be repaid, the company, its workers, and its creditors bear the costs. The PE business model is a *low* risk, *high* reward strategy for PE firm partners.

Post buyout, PE firms often engage in financial engineering that further compromises portfolio companies.

- They may have portfolio companies take out loans at junk bond rates and use the proceeds to pay themselves and their investors a dividend.
- They may split a real estate-rich company into an operating company and a property company, then sell off the real estate and repay investors while the operating company must lease back the property and pay (often inflated) rent.
- They may require portfolio companies to pay monitoring fees to the PE firm for unspecified services. Payment of the fees reduces the companies' liquidity cushion and puts them at risk.

What happens to portfolio companies and workers?

The results of financial engineering are predictable. When the economy falters, the high debt levels of these companies – especially in cyclical industries – make them prone to default and bankruptcy. One economic study found that during the last recession roughly a quarter of highly leveraged companies defaulted on their debts. The financial crisis officially ended in 2009, but bankruptcies among PE-owned companies continued through 2015. Energy Future Holdings, for example, was acquired in 2007 by a PE consortium and defaulted in 2014 with $35.8 billion in debt. Las Vegas based Caesar's Entertainment was acquired by PE in 2006, but by mid-2007 its long-term debt had more than doubled. It declared bankruptcy in 2015, putting over 30,000 union workers at risk.

These examples of job loss are backed by rigorous econometric studies. One study found that through 2005, PE-owned establishments had significantly lower employment and wages post buyout than did comparable publicly-traded companies — despite the fact that the PE-owned establishments had *higher* levels of wages and employment growth than their counterparts in the buyout year. Employment in PE-owned companies was 3.0 to 6.7 per cent lower in the first 2 years after buyout, and 6 per cent lower after 5 years.

What Happens to Limited Partner Investors?

The performance of PE funds depends importantly on how returns on investment are measured. Private equity firms prefer to use the "internal rate of return" (IRR), but that flawed metric has been widely discredited. Finance economists measure fund performance using the "public market equivalent" (PME), which compares returns from investing in PE with returns from comparable, and comparably timed, investments in the stock market.

Recent academic studies find that buyout funds do not deliver outsized returns to investors. While median private equity buyout funds once beat the stock market, they have not done so since 2006 — despite industry claims to the contrary. An important recent study documents a downward trend in PE performance. It found that the median PE buyout fund outperformed the S&P 500 by 1.75 per cent annually in the 1990s and 1.5 per cent in the 2000s, but hasn't beaten the stock market since 2006. PE returns also need to be adjusted for the greater riskiness of PE investments. Industry analysts and most investors assume that PE fund returns should exceed stock market returns by 3 per cent. Clearly, more than half of U.S. PE funds have failed to meet that standard over the past quarter century.

Average PE returns are skewed upward by strong outperformance of top quartile funds. Unfortunately, recent research shows it is no longer possible to predict which funds will outperform the stock market. GPs with top quartile funds have about a 25 per cent chance that their next fund will outperform — same as GPs with bottom quartile funds.

Conclusion

The PE business model is designed to funnel income from portfolio companies and PE funds upwards to the PE firm. With so little of their own money at risk, these firms make outsized bets that pay off in good times. In bad times, they make money on the steep management fees paid by investors and monitoring fees paid by portfolio companies. Like the house in a casino, PE firms never lose.

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Notes:

- *This blog post is based on the authors' book Private Equity at Work: How Wall Street Manages Main Street, Russell Sage Foundation, 2014.*
- *The post gives the views of its author, not the position of LSE Business Review or the London School of Economics.*
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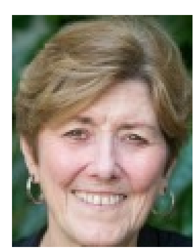

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