

Jack Vogel

600 West Main Street, Northborough, MA 01532

[jackvogel12@gmail.com](mailto:jackvogel12@gmail.com)

(508) 330 2414

Trinity College

# The Role of Private Equity in Enhancing the Market for Corporate Control and Capitalism Itself

*“A stock market is crucial to the existence of capitalism and private property. For it means that there is a functioning market in the exchange of private titles to the means of production. There can be no genuine private ownership of capital without a stock market: there can be no true socialism if such a market is allowed to exist”*

-Ludwig von Mises (quoted in Rothbard, 1995, p.426)

## ***Introduction:***

How are advanced markets possible? In 1932 Adolf Berle and Gardiner Means published *The Modern Corporation and Private Property* and many commentators believe it highlighted a fatal flaw in capitalism. They write that because modern corporations separate ownership and control, it “has destroyed the unity that we commonly call property - has divided ownership into nominal ownership and the power formerly joined to it. Thereby the corporation has changed the nature of profit-seeking enterprise.” If managers can act apart from the interests of investors, a crucial aspect of capitalism, profit maximization, might not work and thereby undermine the system itself. With more than 15,000 citations as of 2016, the influence of this work is far reaching.

Yet it might be the case that the order of the market is more complex than observers like Berle and Means suggest. In 1965 Henry Manne highlighted many unseen features that make markets function. In his “Mergers and the market for corporate control” Manne describes how competition found in stock markets, helps regulate these markets, and the behavior of managers.

Managers that pursue objectives counter to profit maximization will find themselves in charge of a firm worth less than it could be, and when firms are publicly traded, lower stock prices act as giant signals that something is wrong. Similar to how prices convey information (Hayek, 1945) in normal product markets (for example, increased prices in oil signals to producers to look for more oil and signal to consumers to use less) an underperforming stock can signal that the company would be better off restructuring or having new management. A takeover can be friendly and supported by all parties, or a takeover can be “hostile” (a somewhat misleading term) where the shareholders support it but the management does not. The better the market for corporate control, the less it matters what decisions potentially delinquent managers might decide to make.

Manne shed much insight in our understanding of markets, and it must be recognized that the market for corporate control existed before economists understood it (in the exact same way that supply and demand helped coordinate behavior before economists like Menger [1871] described them). The profit motive attracts entrepreneurs to bid on undervalued assets with the hopes of selling them for more (Kirzner, 1973) and that puts constraints on managers and helps stock markets allocate capital to their highest valued uses. Kaufman and Englander (1993) explain that by identifying inefficiencies, financial entrepreneurs have crafted ways to fill the gap through “buying and selling of corporate control, where profits are made by the differential between the purchase price and the organization or redeployment of the firms’ assets.”

An extremely important, but often neglected or maligned, aspect of the market for corporate control is the private equity industry. Think about the negative portrayal of private equity one can observe with Gordon Gekko in *Wall Street* or even the negative comments made by certain libertarians who suggest that Wall Street bankers are just cronies who do nothing of value. Here, I will argue precisely the opposite and describe the crucial role that private equity plays for the smooth functioning of capitalism. Mises (1949) suggests that all capitalists are entrepreneurs

who win or lose based on how well their companies are run. That would imply private equity firms specializing in buyouts, restructuring, and divestiture are included here.

This paper will look at the origins, historical trends, and the role of private equity in the market for corporate control and for creating wealth for businesses and investors. It will describe how the market has evolved and become much bigger and sophisticated in recent years. It will then describe the beneficial effects this industry has on the market for corporate control and on well functioning businesses. Private equity managers offer a sophisticated approach to growing businesses by making such decisions as changing capital structure, improving corporate governance, and aligning their own incentives with the success of capitalism.

### *I. Private Equity: An Overview*

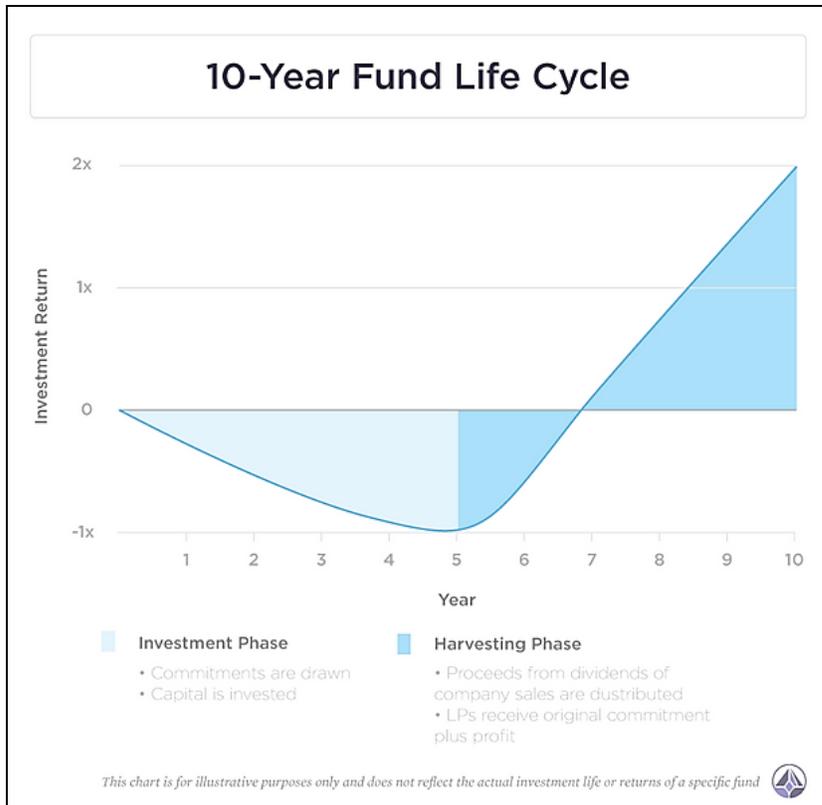
Private Equity (“PE”) firms make investments directly into private companies or buyout public companies and take them private – resulting in a delisting on the stock exchange (Investopedia, “Private Equity”). Masulis and Thomas (2009) explains private equity spreads across many fields, “The categories of investments that fall within the general rubric of private equity include venture capital; midstage company finance; distressed firm investment; LBOs of firms, divisions, or subsidiaries of public and private companies; and going private deals” (Masulis and Thomas, 2009). Let us focus on leveraged work and their effects on targeted firms.

PE funds are structured with three overarching entities: general partners, limited partners, and the companies being bought out. The general partners also known as the PE firm or PE managers oversee the direction and decisions of the fund and are experienced finance professionals. They provide some capital to the fund investments but it is usually just one percent of total invested capital. The limited partners provide the bulk of the capital needed to finance investments but have little to say in decisions made once their investment have been made. These

limited partners are typically institutions such as public pensions, endowments, and high net worth individuals looking to make a return on their capital (Kaplan, and Strömberg, 2009).

Certain critics of capitalism argue that companies will only care about the short run. But here we see the opposite. Each specific fund will have a fixed time period which is typically ten years but can be extended by three more years in certain situations. During this time the PE firm has approximately five years to invest that specific fund's capital into the businesses and five to eight years to provide a return to its investors and the fund (See Figure 1). The private equity firm has a few ways in which they gain a return on their invested capital (Masulis and Thomas, 2009). The first way is through a management fee which is given in terms of a percentage of the total amount of capital invested. The second is through "carried interest" - a share of the profits created by the fund to the general partners to align their incentives toward improving the fund's performance - that is typically negotiated to about twenty percent of profits (Investopedia). Lastly, the general partners can also receive a stream of return through "deal and monitoring fees" (Dechert LLP) for restructuring the companies and providing beneficial daily operation changes (Kaplan, and Strömberg, 2009). Figure 1 shows the cycle and value created in a typical PE deal life:

**Figure 1:**



*Source: (PE &AMP)*

## **II. Financing Techniques**

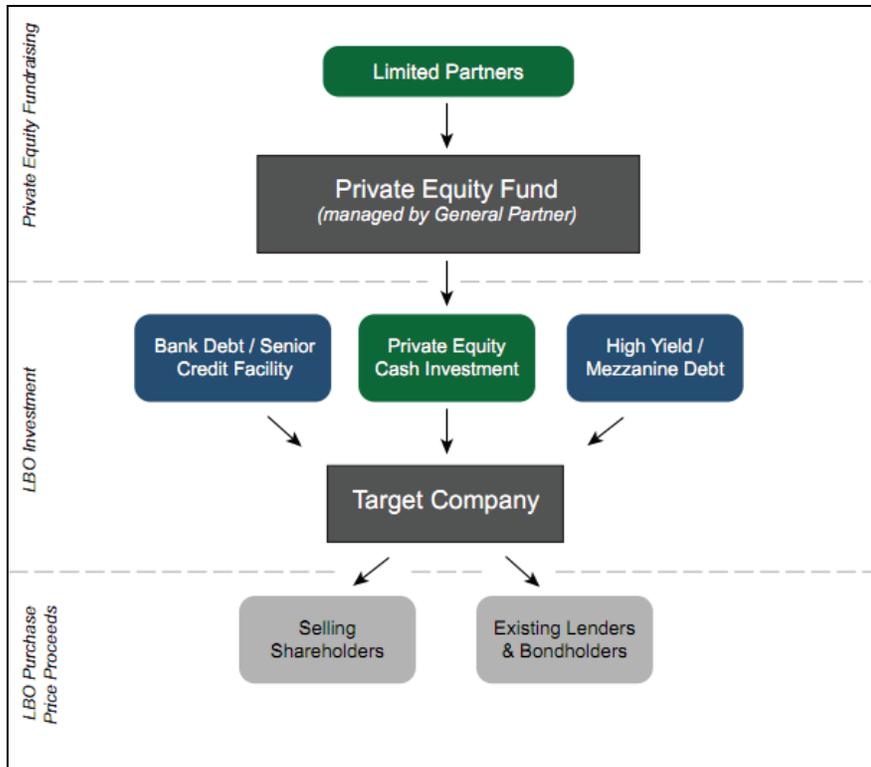
With so much money required, how do private equity firms finance their deals? PE firms typically conduct what is referred to as a leveraged buyout (“LBO”), an acquisition of a company by using a large portion of leverage to borrow against the target companies' assets, but leaving enough money for working capital needs (Kaplan, and Strömberg, 2009).

The process requires appraisal of current and possible future market conditions. Before entering into any buyout the PE firm first makes assumptions about the purchase price which also includes assumptions about the debt interest rate. The next step is to create a “sources and uses” which lists out the way in which the buyout would be financed and how the capital raised would be used (Street of Walls). A typical LBO will leverage a company up to about 90% debt leaving 10%

equity. This results in a high debt/equity ratio leading to higher returns (Masulis and Thomas, 2009). Third, the PE firm projects out the financials five to ten years including how much debt will be paid down, how much working capital is needed and factoring in possible acquisitions that may occur in the future. PE firms look for companies with high levels of free cash flow and agency costs because the value-added for these types of businesses in an LBO restructuring is high (Jensen, 1986). Finally the PE managers look for their exit opportunity which is based on a cash flow multiple (subtracting out net debt). The thorough due diligence helps the PE firm to decide whether they can create value within the business. The bottom line is PE firms take calculated risks through the use a leveraged buyout which creates value by means of improving daily operations, reducing capital and production costs, and looking for further acquisitions of other companies to grow the business (Street of Walls). During this process their incentives to create wealth are intensely aligned with stockholders. Due to the intense due diligence conducted by the PE managers, they also have better access to information which allows for superior decision making regarding operational and strategic planning.

Once the buyout is complete the PE managers take control of the board. The current company management still runs day to day operations but PE managers are sophisticated investors who systematically take this risk with exceptional experience with financing, valuing companies, and growing businesses. This relationship between the PE management can be seen as almost the 'boss' of the board or company management, but labelled as a 'partnership'. That means, "when needed, the private-equity partners can use their control to swiftly alter company policies, remove underperforming executives, or challenge management to perform better" (Masulis and Thomas, 2009). Figure 2 shows a diagram of a typical LBO structure with general partners, limited partners, and the target company:

**Figure 2:**



*Source: Privco*

### *III. Origins of Modern Private Equity*

Private equity is big business, but it has not been around forever. We owe its existence to the entrepreneurial efforts of people like Henry Kravis, Jerome Kohlberg, and George Roberts at Bear Sterns in the late 1960s. At the time these men did these buyout deals on the side from more conventional investments and on a smaller scale. Kravis, who later became the front man for all buyouts, referred to these investments as “bootstrap” acquisitions. During this time they successfully bought out companies such as Stern Metals, Incom, and Eagle Motors, however their manager did not take kindly to the fact it was taking away time from their other work. The three men were forced to split from Bear Sterns and Kohlberg, Kravis, and Roberts started their own firm “KKR” in 1976 focusing their attention fully on these “bootstrap” investments later coined

“leveraged buyouts” which lead to the beginning of the private equity market (The Founding of KKR).

*i. First LBO Boom*

In much the same way that traditional industries grow over time, this is certainly true of private equity. The true commencement of private equity as a viable investment strategy was in 1979 when KKR entered into a LBO of Houdaille Corporation, a massive Fortune 500 company with 7,700 employees (Appelbaum, Eileen & Rosemary Batt, 2012). The financial ingenuity in which KKR financed a buyout without a large commitment of their own capital but instead financed through debt “that was assumed not by the purchaser but by the acquired company” (Appelbaum et al. 2012) set a new precedent on Wall Street. As economics explains, this new superior invention with high profit margins for both the seller and buyer of the service created an influx of suppliers and consumers to the market. In this case, the creation and success of the LBO created an inflow of private equity firms to the market and investments outstanding: “KKR's innovative financial strategies of the 1980s gave way to new strategies and structures that integrated aspects of both financial- and production-centered foci” (Wise, Dena & Zey, 1999).

The first LBO boom started in 1982 and extended until 1990. During this time the amount of private equity outstanding rose from less than \$5BN to \$100BN (Fenn, Liang, and Prowse, 1996). Private equity took off during the 1980s because banks and large pensions need to find alternative investments in the market. The actual size of pensions also grew during that time. Pension funds cumulated \$784 billion in 1980 and by 1990 grew to 2.6 trillion (Chandrasekhar, 2007). This staggering growth led to more money needed to be invested which was coupled with a growing appetite for private equity investments. PE investments started to become recognized by pension funds as a place that would “ensure adequate returns to meet their commitments” (Chandrasekhar,

2007). Additionally inferior performance from major U.S. corporations in the 1970s and underperformance of the stock market during this time provided the opportunity for PE firms to take over companies and increase stockholder value.

The deal that gained the most attention during this time was the takeover of **RJR Nabisco** led by **Henry Kravis** at **KKR**. At the time and for many years to come it was the largest buyout in history valued at \$25 billion in 1988. **RJR Nabisco** was the parent company for the famous **RJ Reynolds Tobacco Company** and **Nabisco**, the snack company that includes well-known brands such as **Oreos** and **Ritz Crackers**. This deal took many months to close as many private equity firms and banks were fighting for the take-over which continued to drive up the price. The management at **RJR Nabisco** was resistant to the deal as they were receiving high compensation and perks to run the business, but **Kravis** knew it was not being run efficiently. After doing extensive due diligence **KKR** put in a bid for \$25 billion which management finally accepted and **KKR** went to work cutting costs and streamlining the corporation (The Washington Post, 1988). This deal that took place twenty eight years ago is still discussed today.

**C.P. Chandrasekhar** (2007) argues relaxation of regulation also led to growth in the private equity market. As part of the **Employment Retirement Income Security Act of 1974**, the **US Labor Department** allowed pension funds to invest in alternative opportunities such as **PE funds**. During the era of deregulation under **Ronald Reagan** incentives were created which led entrepreneurs to take chances on building new businesses, take out loans to grow businesses, and ultimately forge ahead with leveraged buyouts. Tax benefits and the lowering of capital gains allowed **PE firms** to buyout and improve businesses (**Masulis and Thomas, 2009**): “The deregulation of these markets over the last three decades has, in fact, created incentives to shift capital investment from mainstream institutions to alternative ones that have even fewer constraints on how they operate” (**Appelbaum et al. 2012**). The growth and success of the **PE industry** is an example of how strong

policy decisions to allow markets to operate more freely lead to more innovation and wealth creation.

*ii. Second LBO Boom*

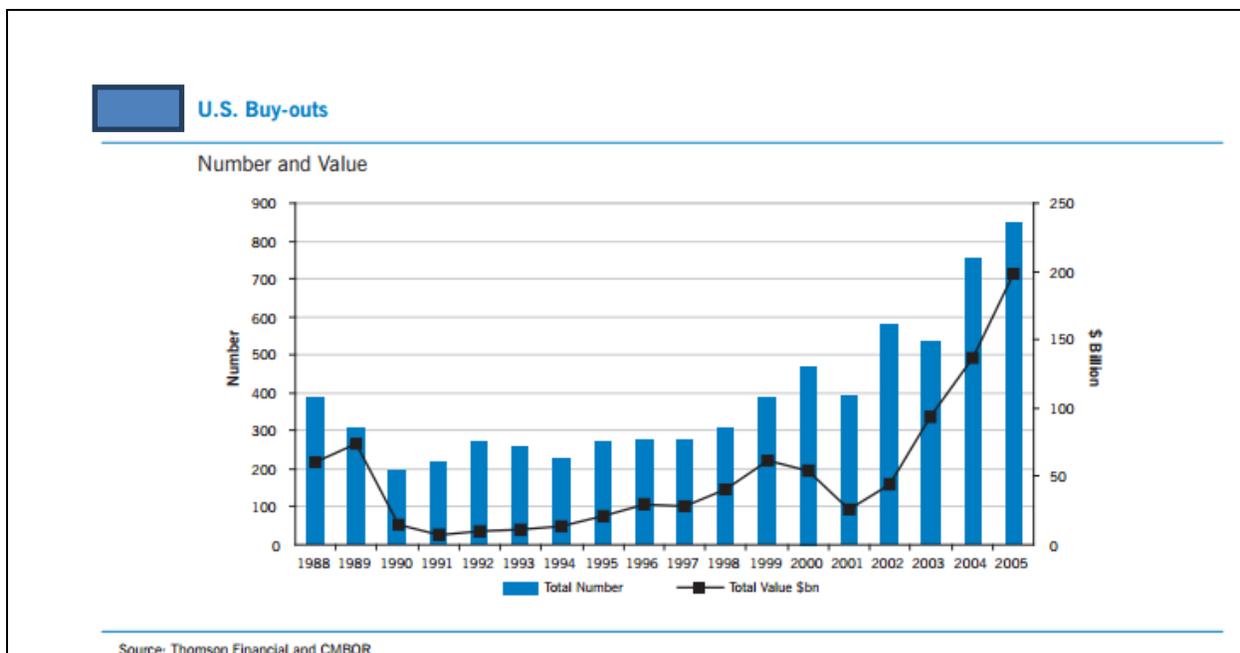
The second major LBO boom occurred from 2002 until 2007 and brought rise to firms such as Blackstone and Carlyle to join the already established KKR. The low interest rate environment coupled with the lower taxes under the Bush administration again created greater incentives for leveraged buyouts. In 2006 alone, the U.S. private equity firms raised \$215BN. During the boom corporate values to free cash flow increased in leveraged buyouts (Appelbaum et al. 2012). PE equity firms were able to provide pension funds and endowments considerably higher returns than stock and bond investing through LBO opportunities which created value to the targeted businesses.

In 2005 the Carlyle Group bought out the Hertz Corporation for \$15 Billion. At the time Ford Motors owned Hertz, but sold off the car rental company to focus on its main operational business and allow Carlyle to expand Hertz further. Carlyle grew the \$15 billion dollar investment to \$25.5 billion - enterprise value - by 2013 (Fortune Magazine, 2013). During the first few years Carlyle focused on streamlining Hertz and cutting costs through making operations more efficient. Then Carlyle looked to expand the company which today is the largest worldwide airport car rental business with 8,600 branches across 146 countries (The Carlyle Group). Another major deal during this period was the acquisition of Kinder Morgan by the buyout arm of Goldman Sachs in 2006 for \$22 billion. Goldman saw the future in U.S. energy production expansion and was able to provide direction for Kinder Morgan to grow their oil transportation network (Market Watch). Kaplan and Stromberg (2008) explain, "By the early 2000–2004 period, secondary buyouts

comprised over twenty percent of total transaction value. The largest sources of deals in this period, however, were large corporations selling off divisions.”

During this time there was also a large expansion of private equity into international markets which did not occur during the 1980s LBO boom: “Buyouts also spread rapidly to Europe. From 2000–2004, the western European private equity market (including the United Kingdom) had 48.9 percent of worldwide leveraged buyout transaction value, compared with 43.7 percent in the United States” (Kaplan, and Strömberg, 2009). PE firms employ thousands of people and create competition in the markets. The private equity firms can be “categorized better as global-asset managers” (Haarmeyer, 2008). KKR for example owned thirty-five companies that brought in \$95 billion in earnings and employed over 540,000 people. On the growth side, the labor market has benefited from staggering prosperity. Great Britain during 2007 averaged 1 percent per year over during a five year stretch whereas employment for those companies owned by PE firms grew by 8 percent (Haarmeyer, 2008). Figure 3 shows the deal count and total capital invested in private equity from 2001-2011:

**Figure 3:**



Source: (Achary, Franks & Servaes, 2007)

### iii. Current Regulatory Trends

Since the financial crisis in 2007-2008, liquidity has come back into the market and allowed for PE firms to continue to make deals. Many corporations have been deemed “too big to fail” but the important thing to note is that there is no need for government intervention to break up these companies. There are private organizations, in this case private equity firms such as KKR, Carlyle, and Blackstone, who have, as Kaufman and Englander (1993) argue, “seriously challenged the managerially controlled firm as the optimal structure for undertaking large-scale production.” PE firms have added two major contributions to the market: they have reduced “collective action problems, particularly public pension funds from acting as a unified control group, and agency costs, which have plagued the large firm since the separation of ownership from control” (Kaufman and Englander, 1993).

One of the major trends since the financial crisis has been a move to diversify the expertise base of the employees at private equity firms. All the top PE managers have begun to hire industry experts in addition to the more classic financially experienced hires from investment banks. For example KKR has hired William Simon, former president and CEO of Walmart, to provide expertise in the consumer industry; Dominique Lafont, former president and CEO of Bolloré Africa Logistics conglomerate to expand into African markets; and Leigh Clifford former Chairman of Qantas Airways Limited to gain insight into the middle east -all as senior advisors to the firm. This is atop other hires such as John Mack, former president and CEO of Morgan Stanley (Kravis, Kohlberg, & Roberts, 2016). The list is extensive and the attraction of the most sophisticated industry experts and finance professions allows PE firms to make better decisions during a buyout and restructuring but also speaks to the success the private equity industry has garnered.

Today PE firms however do face more regulation from government which has been the biggest detractor from their business. The Dodd-Frank act passed in 2010 in light of the financial crisis, forces PE firms to register with the SEC. This means PE firms have to provide information associated with their organization and operations that include investors, employees, and metrics for their funds. The SEC have begun to regulate and oversee the fees PE firms charge their businesses and the amount of leverage they put on companies. These changes have hindered the funds' ability to operate efficiently. Despite the regulation interferences private equity remains a strong alternative investment and continues to provide value to businesses.

#### *IV. The Role of Private Equity for Good Corporate Governance*

Private Equity provides a service which fills a hole that existed within the market - protection of shareholders from companies both public and private from inferior managers. David Haarmeyer (2008) argues that “linking ownership with control and having a large, active and highly interested investor in the boardroom are defining characteristics of private-equity firms and important ingredients in solving the governance problem and creating wealth” (Haarmeyer, 2008). The direct alignment of PE managers’ compensation with the value of the business coupled with the centralization of management into a few managers’ hands in the LBO model has proven successful.

LBO’s are not needed for every company, but do improve efficiency for companies whose management fails to create value. The opportunity for PE firms to enter the market has to do with the idea brought forth by Jensen and Meckling (1976) called agency theory: “Agency theory argues that the employment of a professional staff of salaried managers to run large corporations and the wide dispersion of ownership of shares of stock of publicly-traded companies allow managers - the agents - to pursue their own agendas rather than managing the firm in the interest of its shareholders - the principals” (Appelbaum et al. 2012). An important aspect of an LBO is creating the utmost value in the company through a process of streamlining the inefficient areas and growing the potential opportunities. The PE managers are directly paid through carried interest which is a percentage of the profits they make after paying back the investors. PE firms for this reason are utility maximizers who seek to reduce agency costs, further aligning their interests with company shareholders. Masulis and Thomas (2009) argue, “even the best part-time independent directors are not the equivalent of full time, highly incentivized private-equity managers” (Masulis and Thomas, 2009).

Another major issue related to the principal-agent issue that occurs with certain public corporations is the use of free cash flow. Free cash flow is the cash left over from operating cash

flow after capital expenditures are paid. This cash can be used to pursue investment opportunities to increase shareholder value. Many managers of companies that have below optimal levels of debt on their companies have increased free cash flow which leaves opportunity for misuse. Some CEO will also promise increased dividend payments, but “such promises are weak because dividends can be reduced in the future” (Jensen, 1986). PE firms use debt to more efficiently finance a company. This process of issuing debt forces the PE managers to pay out future cash flows through debt payments. For this reason Jensen (1986) argues that debt is a strong way for PE firms to reduce agency costs of free cash by the reduction of free cash flow that is available for manager use.

This is a solution to the principal agent issue particularly when current management of a public corporation is underperforming; Masulis and Thomas (2009) argue, “Large increases in debt also create strong managerial incentives to improve firm efficiency because they: (1) make stock prices much more sensitive to improvements in firm value; and (2) motivate managers to use firm cash conservatively and to eliminate underutilized assets so as to minimize the risk of bankruptcy, financial distress, and the accompanying forced management turnover.” That means that there is upside compensation but also downside exposure if the PE managers are not able to keep enough liquidity in the business through restructuring or even the opportunity cost of not returning as a high of a profit as they could otherwise in another investment (Haarmeyer, 2008).

LBOs concentrate the ownership of a company into a select few (the PE managers) which allows shareholders to scrutinize and follow management decisions more closely. For example, millions of individuals and institutions own stakes in large corporation which dilutes the feeling of ownership and results in a lack of monitoring on the direction of the company and management decisions. Their ownership is such that there is no incentive to pursue further information or merely they don't have the information as they don't sit on the board. Private equity ownership

provides a stark contrast. The PE managers have a large stake in the business and “informational asymmetry between investors and management disappears” (Haarmeyer, 2008).

### *V. The Role of Private Equity for Creating Wealth in Society*

PE firms focus most of their attention on operational improvement along with financial allocation and structure. The overarching goal is to create value. On the operational side PE firms add value in a variety of lights such as shortening the supply chain, reducing waste in the product, increasing productivity of the sales force (The Founding of KKR), just to name a few. On the financial restructuring and allocation side, PE managers lever a company to optimal levels and look for further acquisitions.

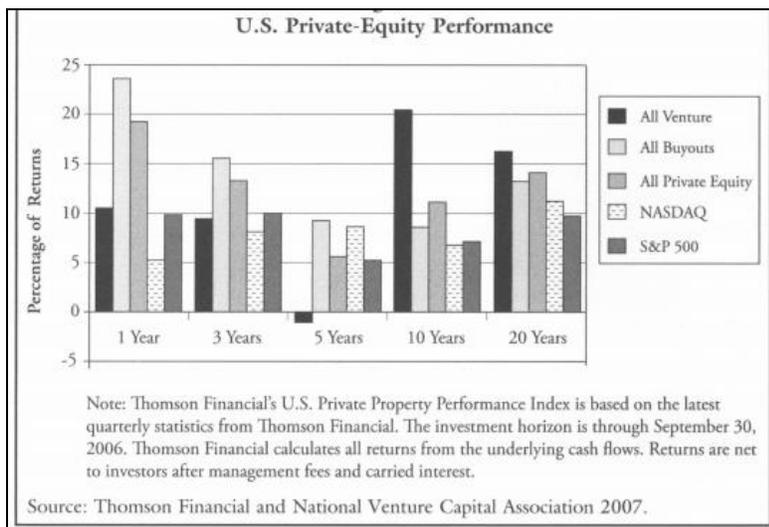
PE firms lever a company to a point that creates a need to streamline a company. In many cases that means selling expansion programs and selling divisions which are of more value to institutions outside the firm - creating a high selling price. The PE manager uses this revenue to pay down debt which means a “much leaner and competitive organization results” (Jensen, 1986).

Private equity investors operate very differently than a typical merger and acquisition (“M&A”) transaction. In the world of valuing companies they tend to pay less than an industry specific business looking for synergy opportunities. This is represented empirically as “acquisition bids from privately held companies tend to push prices up 22 percent, whereas public-company bids drive up the price of a target company by 32 percent (Haarmeyer, 2008).”

Through financial engineering and innovations, private equity has broadened its net by providing alternative investment opportunities to pension funds, endowments, and other institutions rather than to just high net worth families.: “Until the late 1970s, private investments were undertaken mainly by wealthy families, industrial corporations, and financial institutions that

invested directly in issuing firms” (Fenn, Liang, and Prowse, 1996). Competition in the marketplace allowed KKR to innovate and allow professional investors representing these institutions (who further represent the pensions of blue collar workers and college endowments in many cases) an opportunity to grow and diversify their risk. Figure 4 shows the long term growth persistency in buyouts.

**Figure 4:**



Source: (Haarmeyer, 2008)

## **VI. Why Everyone Should be Praising, Not Criticizing, Private Equity and LBOs**

The industry is not without criticism. Critics of the private equity LBO process center their arguments are surrounded around three main ideas: (1) Many critics believe private equity firms use the ‘strip and flip’ techniques leaving the business with a bad business structure after the fund exits. PE managers create large amounts of leverage in a firm to take advantage of tax reductions, cut jobs and company divisions, and create risk of bankruptcy to earn a profit without creating any real value. (2) PE firms look to earn a profit in the short-term and are not interested in the longer term outcome of the business. The PE fund life is approximately 5-10 years which means fund

managers operate on a much shorter time line than managers or CEOs who look at long term investments and profits. (3) More recently economists argue corporations have adapted their business and compensation structure of their managers as a result of PE firms. These changes come in the form of more performance based payoffs closely align public corporations' managers with their shareholders. Some argue this leaves no value for private equity firms today to enter the market.

The first argument that private equity cut jobs and adds no real value is mainly an argument of political implications, not economical. Private equity firms cut employment opportunities in the very short run to reallocate and grow divisions of the business that have a higher cost-benefit affect. This leads to employment increases in the longer term. Lerner and Miranda (2008) show that “the leveraged buyout companies have higher job growth in new establishments than similar non-buyout firms.” Although there may be short-term job placement that occurs, PE firms in the longer term add employment opportunities – also note that increased employment means more taxes paid. The top PE firms by themselves such as KKR, Blackstone, Carlyle Group, and TPG employ millions of people and continue to look for new growth opportunities.

Another important point David Haarmeyer (2008) argues is the sentiment surrounding private equity is very similar to that of capitalism for some people and even notable economists – negative. However the appearance of venture capital firms funding new innovative ideas and investing in new technology is positive. But looking back through history new entrepreneurs such as Bill Gates at Microsoft, Steve Jobs at Apple, or Jeff Bezos at Amazon have “eradicated” many companies who couldn't adjust to the new technologies being built. But short-term job placement is replaced with cheaper goods and services for the consumer, more efficiency, and more and higher quality jobs for employers: “Competition encourages entrepreneurs, owners, and managers to innovate—to think of better ways to organize business, to create more value with fewer resources,

to combine resources more efficiently, and to lower prices (Haarmeyer, 2008).” The freedom of having businesses compete without government intervening leads to greater advancement than any public intervention can provide.

Private equity is a form of financial and operational advancement that leads to innovation and improvement for businesses. It creates competition for public corporations to perform and create value. Private equity is a financial technology that “too in their turn will be shaped, destroyed, and superseded by new organizational forms that will put resources to work more productively and generate additional wealth (Haarmeyer, 2008).”

The second argument of PE firms acting in the short term, assumes that managers of public companies currently look towards longer term growth than the alternative of private equity firms looking to create value on a ten year basis. This simply is not accurate for the companies PE firms target. The current environment in public corporations is a highly intensive with consistent need to meet quarterly earnings estimates in order to satisfy shareholders. In certain cases where management is being run efficiently there is no need for an alternative. In these cases the market is operating efficiently and PE firms will not enter into a buyout of these businesses. However, in certain cases where management makes decisions based on short term gains, eventually leading to longer term underperformance, or fails to allocate resources properly or grow the business to its potential, PE firms will conduct an LBO. In these cases they provide a superior alternative to the current condition and search for longer term value for the business.

The failure of Enron is a great example of a company that needed to hit estimates every quarter and in the meantime made bad short-term decisions that eventually self-imploded the company. The structure of a PE fund forces the limited partners (the investors) to keep the money in the investment for the duration of the fund life. This is juxtaposition to the public companies

that can lose their investors (stock holders) within seconds. Limited partners, due to the longevity of their investment, need to look at the fund's prior performance and decide which PE firm to invest their money. This causes greater competition which is beneficial to the market. In addition, the PE firm knows they can make essential decisions to improve operations or the financial structure in order to create long-term value without losing their liquidity from investors pulling their capital investments. Private equity firms have grown substantially in size which proves that they have been successful by nature as the investors continue to come back and new investors enter the market searching for PE exposure.

Lerner, Sorensen and Stomberg (2011) argue that PE firms do not sacrifice any long term growth at the expense for short term gains. Through the analysis of 472 LBO transactions they concluded that there are actually more patents filled –patents in this case is the instrument to quantify long term growth:

“We find that patents of private equity-backed firms applied for in the years after the investment are more frequently cited. These firms show no deterioration in patent originality and generality, which proxy for the fundamental nature of the research. The level of patenting does not appear to consistently change, and the firms' patent portfolios become more focused in the years after the private equity investments. The areas where the firms concentrate their patenting after the private equity investment, and the historical core strengths of the firm, tend to be the areas where the increase in patent impact is particularly great (Lerner, Sørensen & Strömberg, 2008).”

This study is important as it disputes the long argued critique that PE firms do not create long term investments. Patents are a strong empirical representation of innovation and as the study shows PE firms have continued to support and cite patents in the businesses they own.

PE firms not only look to create value in their 5-10 deal life period, which is much longer than many CEOs needing to meet quarterly earnings, but they also leave the companies in strong

operational standing to continue to provide value in after exiting the business. The argument against private equity is a similar argument to that against capitalism – “few are getting rich at the expense of the many” (Chandrasekhar, 2007). However, looking at both capitalism and private equity within that economic structure, nothing has proven more helpful to the individuals or companies at all economic levels than freedom of markets and competition amongst businesses.

The third argument that private equity is no longer needed also proves incorrect. The innovations that public corporations made are a great example of adjustments and improvements in the market to create greater efficiency; however, that does not mean PE does not continue to create value. PE provided a catalyst to public corporations to make a change and improve incentives between them and their company and shareholders. Although changes have been made, Masulis and Thomas (2009) argue that CEO compensation still has low sensitivity with CEO performance. There is also statistical evidence of low sensitivity between “CEO performance and turnover, and low debt levels leading to unnecessarily large tax payments (Masulis and Thomas, 2009)” LBO’s use larger amounts of debt on a company which provides tax advantages and enhances projects, “these structures were superior to those of the typical public corporation with dispersed shareholders, low leverage, and weak corporate governance (Kaplan, and Strömberg, 2009).” Private equity still provides the missing link for corporations that fail to execute the most optimal operational and financial structure for their company.

## ***VII. Policy Implications***

One of the keys to the relative success of the private equity industry was that it faced lower rates of regulation compared to banks and mutual funds. Historically, regulation of the public financial sector has made it extremely difficult for large public banks to accomplish the same results as private equity firms. One major implementation of regulation that has shaped the

industry and caused inefficiencies in the market is the Sarbanes-Oxley Act. Put in place in 2002 this law placed more requirements on public companies to report further information and puts further restrictions on corporations. The implementation of this policy has put U.S. public companies at a further disadvantage; on the flipside though, it has benefited the private equity industry as it's more advantageous for companies to be private.

Another regulatory issue that had caused issues for mutual funds, for example, and other public trading institutions vulnerable for private equity funds to take them over and run them more effectively is the Investment Company Act of 1940. David Haarmeyer (2008) argues, "A greatly underappreciated factor in private equity's success is that it has taken root in large part because government interference is minimal relative to the regulation of investment in public companies (Haarmeyer, 2008)." Some of the restrictions include constraints on short-selling securities and leveraging up investments. Another constraint forbids mutual-fund managers to be paid on a performance basis but instead need to be paid for percentage of assets under management. These restrictions create the wrong incentives for fund managers and hinder their ability to compete in the market. Private equity has the ability to align incentives between managers and the overall business value which cannot be obtained in the public sector.

Recently, however, private equity firms have been negatively affected by new regulations associated with the 2010, Dodd-Frank act. Not only does Dodd-Frank affect banks and public investment banks but it also regulates private equity firms, which were previously much less regulated. PE firms with more than \$150 million of capital under management now must register with the SEC and provide information with all their funds organization and operational details. This includes new oversight of the fees they charge companies and leverage they put on deals. The

provisions also include stipulations such as banks cannot hold more than 3% of their banking entity in private equity funds or hedge funds.

The new restrictions have affected the PE firms' returns and restricted innovation and competition within the industry. Through the analysis of the private equity industry growth by means of creating incentives for entrepreneurs to innovate it is evident the great advantage of deregulation. Without government interference markets are able to operate more freely and force companies to improve operations, cut costs, and continually serve their customer base. Stringham (2015) argues, "The idea that government is in the background to assist and advance markets is a heroic assumption made by most economists, including those who are otherwise skeptical about government." Regulators should not to hobble the private equity market with a myriad of regulations in the same ways it has hobbled traditional banks.

### *Conclusion*

Markets are extremely complex and made possible by numerous factors that most people do not understand. One can come up with many theories about why firms will be poorly managed and not act in the interest of the shareholders. The private equity market, however, plays a crucial role monitoring and transforming businesses. Private equity firms are sophisticated managers who by the nature of the buyout closely align their incentives with the businesses they oversee. This alignment coupled with their capability of carrying out extremely complex and prudent operational and financial changes allows the private equity funds to create value for the fund, the business, the investors, and the shareholders. It also leads to greater competition and innovation in the market. Private equity is criticized for cutting jobs, thinking short term, and moving a business towards obsolescence, but all are proven to be incorrect as PE firms do nearly the opposite. Although

cutting jobs or liquidation of assets are often necessary and the best course of action for a particular firm empirically, PE funds have demonstrated an ability to generate job growth through careful longer term investments and restructuring. And even for all the firms that are not taken over by private equity, that possibility, or even threat, creates a constant challenge for corporate management to create value.

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