

# research newsletter

## Private Equity

### Introduction

This, the sixth edition of the ECGI Research Newsletter, focuses on the arguably contentious area of private equity. During the recent bull market, the private equity industry grew at a rapid rate. Now, with economies in recession worldwide, some of the deals struck at its height look expensive. Indeed, private equity is seen by some to have contributed substantially to the leveraging of the world economy. Companies that were taken private may need refinancing and unless the financial system starts functioning again, many may go into insolvency. The current credit crisis is the ultimate stress test for the private equity industry.

This newsletter reviews private equity research that was carried out before the credit crisis. This research deals with the fundamental questions that have made private equity controversial. Are private equity buyouts a financial scheme to plunder companies or do they add value by bringing outside expertise, managerial incentives and the will to take difficult decisions to companies? Interviews with an eminent academic authority on this area and with two leading private equity practitioners bring a more contemporary context to this research. These interviews were carried out in late 2008.



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The ECGI is extremely grateful to the Fédération des Experts Comptables Européens (FEE), the representative organisation for the accountancy profession in Europe, for kindly agreeing to sponsor this new initiative over the next three years in recognition of the valuable work they believe the ECGI is undertaking.

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### Research digest

*Seven working papers on this topic have been published by the ECGI. The papers set out the authors' propositions in detail and supply the accompanying evidence. This digest pulls out some of the key strands from the papers which can be downloaded from the SSRN website via the ECGI website [www.ecgi.org/wp](http://www.ecgi.org/wp)*

### The Investment Behaviour of Buyout Funds: Theory and Evidence

by Alexander Ljungqvist, New York University, CEPR and ECGI, Matthew Richardson, New York University and NBER, Daniel Wolfson, New York University and NBER (Finance Working Paper #174/2007)

The authors look at the issues determining buyout funds' investment decisions and link the timing of those decisions, the risk-taking behaviour of the funds and the returns they subsequently earn on their buyouts to changes in the demand for private equity, conditions in the credit market, and the funds' ability to influence their perceived talent in the market.

Over the past 25 years, private equity has grown into a sizeable asset class, with more than 9,000 funds raising in excess of \$1.9 trillion from institutional and other investors. Buyout funds account for 63% of this amount. In contrast to venture funds which typically invest in young, fast growing, private companies, buyout funds usually purchase a controlling interest in an established corporation or one of its product lines, often involving large amounts of debt. Venture funds have received more academic attention but relatively little is known about the investment behaviour of buyout funds.

The authors were able to use a unique and proprietary dataset made available to them by one of the largest institutional investors in private equity. It includes, among other items, precisely dated cash flows representing investments in 2,274 portfolio companies by 207 buyout funds started between 1981 and 2000. The dataset accounts for 35% of all buyout fund capital raised over the period and so affords a comprehensive view of investment behaviour in the US buyout industry.

Using this data the authors found that the return-generating process in private equity varies predictably with a small number of economic variables, such as investment opportunities, competition, and credit conditions, through their effects on the investment behaviour of buyout fund managers. Importantly, they also suggest that new fund managers have strong incentives to invest inefficiently, both in terms of project choice and investment timing.

Fund managers can affect the market's perception of their talent by generating high returns in their current funds. A higher perceived talent enables fund managers to raise more capital in their subsequent funds. As a result, fund managers might be tempted to invest in lower-value but riskier buyouts in the hope of impressing the market if the risky buyout succeeds. The authors show that new fund managers are particularly susceptible to engaging in this risky behaviour and, as a consequence, their investment behaviour is less responsive to market conditions.

The authors show that the competitive environment facing fund managers plays an important role in how they manage their investments. During periods in which investment opportunities are good, existing funds invest their capital faster, taking advantage of the favourable business climate. This tends to lead to significantly better returns on their investments. In contrast, when facing greater competition from other private equity funds, fund managers invest their capital more slowly. Returns on acquisitions made when competition was tougher are ultimately significantly lower. Consistent with this model, looser credit leads to more investment and higher subsequent returns.

Assuming managers' fees are homogenous across funds, investors who have access to funds that are in a position to take advantage of the stickiness of private equity capital should earn excess expected

returns. Other investors earn normal risk-adjusted rates of return. The fact that younger funds take larger risks can help explain the negative expected returns found for first-time funds. Investments in first-time funds provide investors with an option to invest in the fund manager's later funds if the first-time fund has been successful. Thus, investors may actually earn normal expected returns on first-time funds and increased returns on later funds. Following periods of good performance, funds typically become more conservative and this effect is stronger for younger funds. As the authors point out, this hypothesis does not explain why the successful, mature funds allow their investors to achieve excess returns by not raising management fees.

### **Why do private acquirers pay so little compared to public acquirers?**

*by Leonce Bargeron, University of Pittsburgh, Frederik Schlingemann, University of Pittsburgh, René Stulz, Ohio State University, NBER and ECGI, Chad Zutter, University of Pittsburgh (Finance Working Paper # 171/2007)*

The authors found that on average shareholders in an acquired company gain more if the acquirer is a public company than they do if the acquirer is a private equity firm. They argue that the differences in managerial incentives between private and public firms have an important impact on target shareholder gains from acquisitions and that managers of firms with diffuse ownership may pay too much for acquisitions.

On the basis that most acquisitions by private firms are paid for with cash, the authors constructed a sample of cash-only deals completed between 1990 and 2005. The sample consisted of 407 deals by private firms and 885 deals by public bidders. The authors found the difference in premiums between these two types of acquisitions to be sizeable in their sample. The average gain for target shareholders when the bidder is a public firm is 31.74% over the three days surrounding the announcement of the acquisition. This is 43% higher than the gain for shareholders when a private firm acquires their firm and 55% higher than the gain when a private equity fund is the acquirer.

Having documented this dramatic difference the authors went on to investigate why this should be

the case. The simplest solution, they suggest, is that private and public firms acquire different types of targets, in particular, that private firms tend to acquire targets that have performed less well than the targets acquired by public bidders. However, the authors found no evidence that differences in either deal or target characteristics explained the differences in premiums between private and public bidders.

If target and deal characteristics cannot explain the differences in premiums, the authors argue that it must be that bidders make different offers for similar targets depending on whether the bidder is public or private. They found evidence consistent with what they call the managerial discretion theory of takeovers i.e. that in the context of acquisitions, managers may gain from acquisitions that do not benefit shareholders – the acquisition could bring increased remuneration and benefits, provide added prestige because the company is now larger which also makes it less prone to potential hostile takeovers. The authors say that such an argument could make sense if the private firm acquirer can offer the promise of continued employment to target managers and the possibility of a large payoff if they improve the firm enough that it eventually goes public. With this hypothesis, however, they expected that the difference in shareholder gains between the two types of acquisitions would fall as the share ownership of target managers increased because, as their stake increases, they lose more from a low premium acquisition. They also expected the difference between the two types of acquisitions to fall as the ownership of institutional shareholders increases because these shareholders have greater ability and incentives to force management to seek improvements in the premium offered. They found no evidence that the difference in target shareholder gains between acquisitions by public bidders and by private bidders is related to managerial ownership of the target. However, they did find evidence that target shareholder gains do depend critically on the managerial ownership of the bidder.

The authors assumed that private bidders have concentrated ownership and that managers have high-powered incentives. They found that the difference in abnormal returns is highest between acquisitions made by private bidders and by public acquirers with low managerial ownership. As the

managerial ownership of the public bidder increases, so that the ownership of the public acquirer becomes more similar to the ownership of the private acquirers, the difference in abnormal returns between the two types of bidders becomes small and insignificant. The differences in managerial incentives between private and public firms have an important impact on target shareholder gains from acquisitions and managers of firms with diffuse ownership may pay too much for acquisitions.

### **Leveraged Buyouts in the UK and Continental Europe: Retrospect and Prospect**

*by Mike Wright, Nottingham University Business School (NUBS), Luc Renneboog, Department of Finance, Tilburg University and ECGI, Tomas Simons, Amsterdam Office and McKinsey & Co. Inc, and Louise Scholes, Centre for Management Buyout Research (CMBOR), University of Nottingham (Finance Working Paper #126/2006)*

Management buy-outs have become a global phenomenon. This paper examines the key market trends in the UK and Continental Europe and identifies challenges for the future development of the market. The past 25 years has seen a period of significant growth. The UK is the most developed buyout market in Europe but there has also been considerable buyout activity in France, Germany, Italy, Spain and the Netherlands.

The UK buyout market in particular now faces a number of formidable challenges - notably, finding new deals at attractive prices while competing with new market entrants, devising lower-cost ways to fund deals, and effecting timely exits capable of producing targeted rates of return.

The trend among buyout firms has been to raise fewer, larger funds. Institutional investors have indicated that they are likely to reduce their investments in all types of private equity in the future, but they also say that their investments specifically in buyouts will grow in importance as a percentage of their total commitment to private equity. By contrast, evidence from Continental Europe indicates an intent by institutional investors to increase their commitments to investment in all forms of private equity, including buyouts.

In addition to the funds raised and invested within Europe, in recent years US private equity firms have

become much more prominent investors in European buyout markets. The authors explain this with reference to the increased competitiveness of the US buyout market and hence declining returns on US deals; the reduced appetite of institutional investors for early stage funds since the end of the dot.com era; and greater opportunities for restructuring in the UK and Continental Europe.

Since the late 1990s, the major changes in the relative prominence of different deal types have been the growth in importance of both secondary buyouts and public-to-private buyouts (PTPs). Due to the high costs and risks associated with such deals, the first PTPs were relatively small and invariably involved incumbent management. But, as the process became better understood and those initial deals were successfully completed, there was a growing tendency towards larger and investor-led or institutional buyouts of larger public companies which suggests that the opportunities to restructure listed corporations by taking them private may be greater than once thought.

The severe challenges being experienced in exiting smaller deals also caused a shift of attention to larger deals. Although private equity providers had previously been reluctant to purchase companies from each other, the pressure for existing private equity firms to obtain an exit due to the limited life of their funds helped them overcome their reluctance. Much of the impetus for private equity providers to buy portfolio companies from other financial investors has come from the difficulties in finding attractive deals from other sources as corporate restructuring programs passed their peak and auctions pushed up prices. There were 91 secondary buyouts in 2005, as compared to just 29 in 1995.

As deal size increased from the mid-1990s, so did financial innovation. As a reaction to the ruling environment of low nominal yields and the dampening of volatility in traditional asset classes, from 1997 onwards, UK financial institutions became willing to invest in high-yield, non-amortising senior debt instruments. Such instruments enabled buyout financiers to operate with highly leveraged capital structures but without creating foreign exchange risks. The securitisation of such leveraged loans, already popular in the US buyout market, also gained momentum in the UK and Continental Europe during this period.

There are important differences among European countries in terms of the supply of buyout opportunities. In the UK most opportunities have come from the restructuring of diversified groups, with going private transactions becoming more important only in recent years. In France, by contrast, the marked growth in buyouts has been driven mainly by succession and portfolio reorganisation issues in the large number of family controlled listed and unlisted companies.

In Germany, Spain, and Italy, the reluctance of founders of small and medium-sized firms to sell to private equity firms has restricted market growth. As a result, divestments and secondary deals have been the most important sources of buyouts in these countries. In Central Europe, the transition from communism has been the main source of opportunities as many state-owned firms were privatised, though these volumes have steadily declined in recent years.

As far as future challenges to private equity are concerned, the general sentiment is that too much capital is chasing too few deals which perhaps suggests the need for rationalisation and consolidation of the industry. The fact that there continues to be a large number of family owned firms in Europe where the founders may not be willing to sell, or if they do sell expect to have a continuing role in the business, will affect the availability of opportunities. The entry of hedge funds into the Continental European buyout market poses a competitive challenge to private equity firms in terms of deal sourcing. Pressure to generate high exit returns over the short to medium term and limits on the further use of leverage as a value-creation mechanism means that private equity firms will have to make their buyout operations even more efficient and are increasingly likely to have to differentiate themselves through their operating capabilities and possibly industry specialisation.

As the economies of Europe enter recessionary conditions, and in an environment of major problems being experienced by the banks making debt for buyout deals hard to come by, market conditions have recently become much more difficult. Both deal value and deal volume have fallen sharply, especially at the end of 2008. Significant increases in failures and restructurings of buyouts are expected but, in parallel, past recessions also suggest that buyouts will be used to rescue and turnaround failed firms.

### **Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets**

by Ronald Gilson, Stanford Law School, Columbia Law School and ECGI, Charles Whitehead, Boston University School of Law (Law Working Paper #086/2007)

The authors argue that, in increasingly complete markets, private owners can transfer risk in discrete slices to counterparties who, in turn, can manage or otherwise diversify away those risks they choose to forego, arguably becoming a lower cost substitute for traditional risk capital. For some, the benefits of public ownership may continue to outweigh the associated agency costs but for others changes in risk transfer may have implications for how a firm is governed.

Changes in the capital markets have led to new risk management techniques and instruments, including sophisticated derivatives and insurance contracts (such as, for example, insurance contracts designed to protect firms dependent on agriculture from the impact of bad weather affecting crop yields), which enable firms and private owners to transfer risk in discrete slices as opposed to a broad transfer of risk to purchasers of common stock. Risk counterparties can, in turn, diversify or transfer risks they choose to forego, arguably becoming a lower cost substitute for the broad spectrum of risk-bearing traditionally assumed by public shareholders.

The authors suggest a number of ways in which focused risk management at the firm level may be more efficient than broadband risk-bearing by diversified shareholders. Advances in risk management may, consequently, result in a deconstruction of equity. The more a firm is able to identify and hedge its risk exposure, the less equity it may need to support its operations. If risk management can begin to substitute for equity, with firms relying instead on debt to fund working capital, then the traditional model's reliance on public equity, and the corresponding agency costs, may become optional.

Another impact of the increasingly complete capital markets is the ability of shareholders to decouple economic ownership from voting rights, through stock lending, equity swaps, derivatives and other trading strategies, challenging a central precept of the publicly held corporation that assigns voting rights to common stockholders because they bear residual risk.

The authors point out that recent scholarship has deconstructed the corporation into a 'nexus of contracts,' rejecting a characterisation of the shareholder as 'owner' in favour of one in which the corporation is an equilibrium among actors, including shareholders, creditors, and managers, who bargain within a complex set of relationships with the corporate entity at the centre. In this framework, investors rely on the liquidity of the public markets to inexpensively manage risk by diversifying their holdings across a spectrum of firms and, as residual claimants, shareholders bargain for ownership-type benefits, such as voting rights and fiduciary duties, to constrain the resulting agency costs. Diversified risk-bearing at the shareholder level was presumed to be the least costly means to manage firm risk, even after taking into account those costs.

They go on to consider this new border between public and private ownership. The recent private equity wave witnessed an enormous shift away from public ownership, and presumably a shift in the balance that dictates an owner's decision to go public in the first place. The increasing ability to shift risk by the slice moves the border towards privatisation, but still leaves significant room for a vigorous public market, in the authors' opinion. For the time being at least, the public market provides benefits that are not available through other means. Until those benefits can be provided by other institutions, public ownership will continue to play a meaningful role in the capital markets. The key thing is in understanding the continuing benefits, beyond the mere facilitation of risk-bearing, provided by the dispersed ownership of equity.

### **Regulation of Private Equity - Backed Leveraged Buyout Activity in Europe**

by Eilís Ferran, University of Cambridge and ECGI (Law Working Paper #084/2007)

Private equity-backed leveraged buyout (LBO) activity in European markets has risen to unprecedented levels in recent years. This has yielded significant economic benefits but it has also prompted deepening concerns about excessive leverage, conflicts of interest, market abuse and general lack of transparency.

The size and complexity of many of the recent private-equity funded LBO transactions generate a large flow of price sensitive information that is open to abuse by persons within private equity firms

or who are otherwise involved in transactions. A recent discussion paper by the UK Financial Services Authority (FSA) classifies market abuse in private equity transactions as a risk of high significance, taking into account both impact (the potential harm that could be caused) and probability (how likely the event is to occur). In addition, the high levels of debt typically associated with a LBO makes the target companies very vulnerable to interest rate rises and downturns in the market.

Exiting investee companies at a favourable time is central to the business of private equity firms. This gives rise to a potential conflict of interest in that a private equity firm's assessment of the best time for a flotation, or other form of exit, may not coincide with the company's interests and may lead to long-term problems if that step was taken prematurely. In addition, a private equity firm only has a limited number of expert managers and will want to use them across their portfolio of companies to generate the best returns, another potential conflict of interest as managers are moved from one portfolio company to another. The FSA has ranked conflicts of interest alongside market abuse as a risk of high significance

The author reviews key recent regulatory changes in Europe which, though not necessarily conceived with the private equity-backed leveraged LBO segment of the market specifically in mind, may have significant repercussions for it. In particular, she considers Article 23 of the Second Directive. This contains a rule prohibiting public companies from giving financial assistance for the acquisition of their shares. This appears to strike at the heart of LBOs because the economic structure of these transactions depends on being able to use the acquired company's assets as security for the debt financing incurred to effect the acquisition but the author quotes Luca Enriques who has made the point that the sheer volume of private equity buyouts in Europe indicates that the hindering effect of Article 23 cannot be as great as is often contended. What has happened in fact is that ways have been found to limit the effect of Article 23 in relation to LBO activity. These techniques have emerged against a background that has shifted from viewing LBOs as invariably questionable transactions in which sharp operators play the market for corporate control with other peoples' money to seeing them

in a much more benign light as at least potentially economically worthwhile, value-producing activities.

Private-equity funded LBOs form a booming segment of European market activity. Capital has flowed into private equity because world-wide economic conditions have provided investors with large amounts to invest for which they are seeking returns greater than are available from the public markets. In recent years private equity funds have outperformed other asset classes. The growth of private equity funded buyout activity in Europe also owes much to the fact that it is a maturing business segment that is benefiting from a track record of achievement by private equity firms. Given the role that private equity can play in channelling investment capital into the corporate sector and in providing attractive investment returns to institutional investors it is unsurprising that there is a deepening interest in it among European policymakers. For these policymakers, the challenge is to maintain a balance between competing considerations regarding the benefits and dangers of highly leveraged activity and the running of major companies outside the transparency constraints of the public markets so that economically worthwhile activity can take place but abusive conduct that is socially wasteful is effectively curtailed.

### **The Eclipse of Private Equity**

by Brian Cheffins, Cambridge University and ECGI, John Armour, Cambridge University (now Oxford University) and ECGI (Law Working Paper #082/2007)

The credit crunch that began in the summer of 2007 has had a strongly adverse impact on private equity. Private equity buyouts of public companies have dropped precipitously from the levels seen in the mid-2000s, both in terms of the number and value of transactions. The ECGI working paper version of Cheffins and Armour's paper was written before the credit crunch got underway but predicted in a prescient manner that the seemingly inexorable growth of private equity could not be taken for granted. The précis of the paper which follows is based on the arguments as the authors made them, which accounts for the fact that some of the arguments advanced are somewhat dated (or obvious).

The taking private of public companies by private equity has potentially crucial ramifications for the shape of capitalism. The authors argue that, although private equity has considerable momentum, it is unlikely that private equity firms will marginalise the stock market by acquiring and taking private ever larger public companies. Instead, they argue the current set of market and legal conditions, which are highly congenial to public-to-private transactions, could be disrupted in ways that cause the private equity surge to stall or even go into reverse. If the switch in momentum is strong enough, the private equity model could be discredited, causing at least a temporary eclipse of private equity.

Cheffins and Armour, to put their arguments into context, describe the basic mechanics of the transaction most commonly associated with private equity, the buyout and taking private of publicly traded companies. In so doing, they draw attention to the potentially beneficial attributes of public-to-private buyouts, namely the robust performance-oriented incentives provided to managers of the companies taken private and the 'hands on' monitoring provided by private equity firms with the companies they have bought. They point out that the fact that buyouts are executed by funds with a fixed duration provides both managers and private equity firms with robust incentives to carry out intended reforms promptly.

The private equity buyout boom was a key element in the latest in a series of merger waves the U.S. has experienced since the late 19th century. Of the previous merger waves, the two that can be paralleled most readily with the private equity boom are the ones occurring in the 1960s and the 1980s. A distinguishing feature of the 1960s merger wave was conglomerate mergers, which resemble private equity buyouts, and the buyout boom was led by the 1980s predecessors to today's private equity firms, known as 'LBO associations'.

A conglomerate is a corporation that owns companies operating in a number of largely separate market sectors and lacking a well-defined connection between the products and services offered. Conglomerates can, in theory, result from internal growth as the parent company launches operating companies in a variety of different industries, but the standard pattern is growth by merger. This begs comparison with today's private equity firms, in that

they, as with conglomerates, carry out numerous acquisitions covering a wide range of industries and normally take the companies they buy private. The authors concede private equity differs in key respects from the conglomerate, acknowledging private equity firms should be better placed for hiring and retaining good managers and at creating the right mix of incentives and penalties for those managers. Still, the experience with conglomerates is instructive since 1960s conglomerates, as with leading private equity firms today, developed an enthusiastic following among investors, were characterised as capitalist trend-setters and were politically controversial.

Conglomerates became largely discredited in the 1970s. The leveraged buyout boom of the 1980s tailed off precipitously in the 1990s. Drawing on what occurred in both instances, the authors identify various factors that could contribute to the decline of private equity. The first is declining share prices. If share prices decline, this makes private equity buyout targets cheaper, but makes it much harder for private equity firms to orchestrate exits on favourable terms, thus eroding returns and making it more difficult for private equity firms to raise funds for buyouts. The second is a deteriorating market for corporate debt. Noting that cheap debt is the rocket fuel for private equity buyout boom and that a chill in debt markets helped to end the conglomerate mergers of the 1960s and the buyout wave of the 1980s, the authors predict that a change in highly favourable debt conditions could drastically undercut private equity buyouts.

A third factor that could throw the private equity boom into reverse is too few appropriately priced targets. With the conglomerate mergers of the 1960s and the leveraged buyouts of the 1980s, as merger activity peaked, the prices being paid for companies was too high, which ultimately served to discredit the conglomerates and LBO associations. As private equity buyouts surged, prices being paid were again very high, implying a potential decline in returns that could make it difficult for private equity firms to raise funds going forward. Fourth, and finally, regulation could come into play. Regulatory changes handicapped both the conglomerate mergers of the 1960s and the leveraged buyouts of the 1980s, though due to changing market conditions it is difficult to ascertain whether the reforms introduced had a serious impact on M&A activity.

For private equity, a prolonged period in the political limelight could result in an unfavourable regulatory terrain for public-to-private buyouts.

Cheffins and Armour acknowledge that the factors that potentially could precipitate a reversal in private equity buyouts might not have a serious adverse impact on public-to-private buyouts over the long haul. They nevertheless predict that the nature of buyout activity could change fundamentally. At the time of the private equity boom, because the buyouts were being executed by private equity firms organised private partnerships, it seemed the future of the publicly traded company was being thrown into question. The authors argue this is the incorrect inference to draw because if the private equity buyout activity remains robust the market leaders in the private equity field will likely end up being publicly traded. As a result the taking private of publicly traded firms would occur under the umbrella of private markets, implying a permanent eclipse of the current private equity model.

### **Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance**

by Ronald W. Masulis, Frank K. Houston Professor of Finance, Owen Graduate School of Management, Vanderbilt University and Randall S. Thomas John S. Beasley Professor of Law and Business, Vanderbilt Law School, Vanderbilt University (Law Working Paper #113/2008)

The growing use of, and trading in, derivative instruments by corporations has eroded the effectiveness of several critical corporate governance mechanisms as illustrated by the subprime mortgage and banking crisis.

Board monitoring at public corporations has been seriously undermined by the growing use of derivative contracts. These securities allow firms to acquire large financial risks on short notice. This situation differs greatly from the pre-derivative environment where a major change in firm risk exposure generally required either a highly visible M&A transaction or a large new investment initiative, both of which take a relatively long time to implement, are easy to observe and need explicit board approval. Financial engineering techniques now allow a firm to change its risk exposure almost on a moment's notice through

the use of derivatives, which makes its risk profile much less transparent and much more dynamic. The complexity and flexibility of these instruments raises monitoring costs for directors. The problem has been compounded by the failure of many derivative traders to require highly detailed information on the assets underlying their financial contracts.

Public corporations are growing in size due to internal growth and global consolidation within industries. One result of this is smaller percentage shareholdings by their boards of directors, which results in weakened incentives for directors to monitor firms carefully. This can be reinforced if directors are paid with short-term bonuses and stock options because these forms of compensation have short time horizons, making directors less focused on the long-term value of the firm's stock. At the same time, firms are becoming more complex (geographically and technologically) and bigger, again making them more difficult to monitor.

In addition, there has been a shift toward nominating directors based on their independence from management, rather than their financial expertise and strategic insights into the business, because of strong concerns about board independence. While recent reforms of stock exchange listing requirements have tried to encourage more financial and familial independence of outside directors, there continues to be serious concerns about the social independence of many directors. The fear is that members of the same country clubs and social circles may have trouble aggressively confronting their compatriots in the boardroom.

Effective corporate governance relies on reliable and timely reporting of corporate performance measures for good internal board monitoring and outside investor evaluation. Without accurate and timely information on firm performance and risk taking, it is nearly impossible to evaluate how well a firm is performing and whether investors are getting an appropriate market return for the risk that they are bearing. Given the speed with which derivatives can affect the risk exposure of a firm and the time lag inevitable in traditional financial reporting, it seems almost impossible for boards to obtain accurate and timely information.

The problem is particularly prevalent in financial institutions. Over the last half century, financial

institutions have grown dramatically in their asset holdings and have become much more diffusely held. Shareholder oversight at these institutions has therefore become less effective since few shareholders own a large enough percentage of the outstanding shares to be strongly motivated to carefully monitor the firm's senior managers. Likewise, senior management's percentage equity ownership is generally extremely small, implying poor alignment of interest with shareholders.

Financial service firms such as banks, mutual funds, and insurance companies are often highly active derivative traders and market makers, exacerbating the inadequacy of current quarterly disclosure requirements, which fail to illuminate undercapitalisation problems and large risk exposures. Financial engineering techniques also make it much easier for financial institutions to circumvent regulatory portfolio restrictions designed to limit their risk taking, and to avoid recognising losses on a timely basis. This means that unless their derivative positions are continuously monitored, they can affect huge changes in risk bearing in relatively short periods of time.

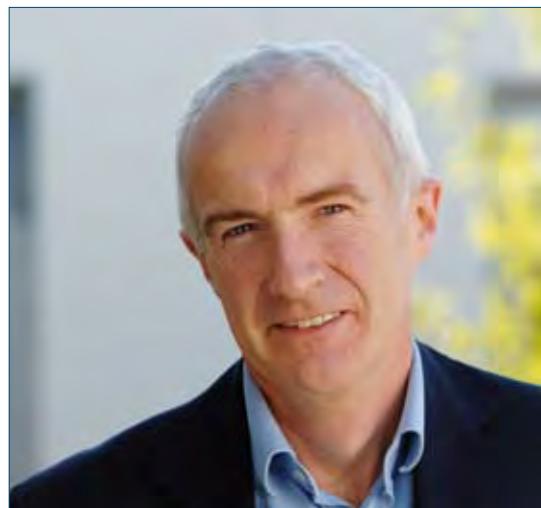
The authors argue that private equity ownership is, and will continue to be, a very effective way of addressing the above concerns. Private equity involvement strengthens board monitoring of derivative exposures by reducing board size, improving information flows to the board through instituting specialised reports, increasing board control over managers, sharpening director financial incentives to monitor derivative exposure carefully and intensively, and attracting highly qualified directors, better able to understand the associated risks. It also creates manager incentives to carefully evaluate a firm's risk-return tradeoffs.

The authors also argue that large increases in debt create strong managerial incentives to improve firm efficiency. This is because it makes stock prices much more sensitive to improvements in firm value and also because it motivates managers to use firm cash conservatively and eliminate under-utilised assets so as to minimise the risk of bankruptcy, financial distress, and forced management turnover. Moreover, a small number of private debtholders (generally institutional investors) can further improve firm monitoring since they are large, sophisticated investors, who frequently hold both debt and equity

positions in private equity controlled firms. This gives them access to proprietary firm information flows and strong incentives to intensively monitor a firm. Thus, the shift toward greater private equity ownership in the economy can be viewed as a value-creating response to increased derivative trading and holdings with enhanced risk exposure levels, especially in less competitive industries, where product market competition is a weaker alternative mechanism for motivating managers to improve firm efficiency and profitability.

## An academic viewpoint

**Tim Jenkinson** is Professor of Finance at the Saïd Business School in Oxford and is Director of the Oxford Finance Research Centre. His research is on private equity, initial public offerings and securitisation.



*Tim Jenkinson*

One of the most controversial claims regarding private equity investments, in particular of the leveraged buy-out variety, is that they are predicated upon getting rid of jobs. However, Tim believes that such claims are largely unsubstantiated and that this debate has deflected attention from the fundamental issue of whether the private equity governance model is effective. Just like any public company, a private equity owned company will go through periods where they take on workers and also periods where they reduce their labour force. The fact that there has been an awful lot of political interest

in whether or not they are destroying jobs is, in many respects, secondary to the issue about whether they are adding value and making companies more productive and competitive in international markets.

*"Trade Unions have been very successful in raising the issue of employment up the political agenda, even though the main focus of attention should really be on the creation of value. I think that the evidence on whether private equity firms create jobs, is very difficult to interpret because it isn't just a matter of looking at the headline figures as jobs which are lost in one part of the business may be recreated in another. It's only now that academics are starting to look at this area seriously."*

The big unresolved issue in Tim's opinion is just how good an investment private equity really is? Do private equity firms add value and if they do, how do they do that?

The three main ways in which private equity firms can create value for their investors are: financial balance sheet efficiency - taking a company with very low levels of debt, putting more debt into the capital structure and thereby reducing tax payments and reducing the free-cash flow available to management; timing the market - buying a business cheaply and selling it when its gone up in value; and making operational and governance improvements which simply make the business more efficient and more profitable. Private equity firms can bring a very clear strategic vision and execute that strategy quickly and effectively. They empower management to make a real difference and incentivise them well. Often senior management will be offered a stake in the business but they will need to invest their own money, usually an economically significant amount. The combination of personal loss in the event of the company not doing well with the promise of large personal gains if it does acts to focus the executive team. There is a downside risk but there is also a very large upside gain, arguably, far larger upside gains than would be countenanced by investors in public companies.

Publicly owned companies have to follow the various governance codes and listing regulations, often designed to protect minority shareholders, and need to communicate with their dispersed shareholders in a very disciplined and timely manner. This means that Boards often spends a lot of their time on compliance with those rules. Contrast this with

the private equity owners who essentially own the company and are almost entirely focussed on how to make more profit.

*"The evidence that exists at the moment on whether private equity really does add value is patchy because private equity firms are quite secretive. Private equity returns vary hugely across managers. Whereas the difference between being a good and a bad mutual fund manager is maybe one or two percentage points, in private equity the difference between a top quartile and a bottom quartile performance is more like 20 percentage points. Therefore, the very best firms, systematically, do create value. However, the evidence also suggests that, on average, a significant proportion of the value created by private equity firms is appropriated in the form of fees and profit shares that are charged by private equity funds to their investors. Gross of those fees, the performance can look good but net of the fees the average performance looks less impressive. This is one of those areas which is absolutely crying out for research: so far, the availability of data here has been a major problem and we are only at the very start of understanding what the risk and return characteristics of this asset class actually are."*

*"One of the reasons I say this is because by its very nature private equity is extremely difficult to analyse from the point of view of performance because you don't really know what the total return is until the fund has closed – most of them have a 10-year life – and even then not all funds report their performance to the various data providers. Most of the academic evidence that exists at the moment, looks at funds which were started before about 1997, because those 1997 vintage funds are more or less finished by now. But, more money has been raised in the last decade than had been raised in the whole of previous history. The funds have not liquidated yet, so we don't know what the situation is. Even though by my estimates about 1.5 trillion dollars of equity has been raised in the last ten years, we know little about their returns, and how they compare to other assets – such as investments in public equity – on a risk-adjusted basis."*

*"The impact of the credit crunch is, of course, extreme because of the lack of liquidity in the banking sector. But, having said that, private equity funds themselves are sitting on hundreds of billions of dollars of uninvested capital, commitments from investors which*

*they are expecting the funds to find targets for.*

*So the market is not going to go away but the levels of leverage in the deals will come back down. At the height of the boom deals were being done at historically high valuations with historically high levels of debt. Those valuation and debt multiples have, not surprisingly, reduced significantly. Indeed, at present the supply of debt has more or less dried up, resulting in a very low number of new transactions. But lending will return at some stage during 2009 or 2010, albeit at much reduced levels of leverage, higher margins, and with more onerous covenants.*

*"Furthermore, private equity firms are finding it much more difficult to take money quickly out of deals, which was the other feature of the credit boom in 2006 and the first half of 2007. At this time, private equity firms would initially borrow a certain amount to buy the company, and then, because the market was so willing to lend, they would then go back and take on additional debt several months later which would enable them to pay themselves a dividend. In some cases such dividends exceeded the original equity investment by the private equity funds. That type of re-capitalisation is definitely not going to happen in the foreseeable future and so the holding periods of private equity are going to extend significantly. They are going to have hold on to their portfolio companies for much longer. The lack of exit routes for many companies at present has resulted in over-allocation problems for some investors in private equity funds, and is contributing to the challenging environment for fundraising – even though the 2009 and 2010 vintage funds might well deliver excellent returns."*

## A practitioner viewpoint

**Humphrey Battcock** is a Managing Partner, based in the London office of Advent International. Advent celebrates 25 years of business this year and is one of the world's most geographically diverse private equity firms. Humphrey has worked in private equity for over 21 years and enjoys the opportunities that private equity provides to energise and liberate a management team to get the best out of a business. *"Managing a non-core subsidiary of a much larger organisation can be quite unexciting, it is probably never going to be the focus of the main board," he explains. "But if private equity provides the management team with the opportunity to take over*



**Humphrey Battcock**

*the business and run it themselves, then the focus is entirely on that business and the team is liberated to really make the best of the available opportunities and in my experience management usually responds very positively to this approach."*

Since 1984, Advent has invested in nearly 600 companies in 35 different countries and at the heart of their strategy is a very clear sector focus. It invests in 5 key sectors; Business and Financial Services; Retail and Consumer; Technology, Media and Telecoms; Healthcare and Life Sciences; and Industrial. By concentrating on these specific sectors, Advent has built up an expertise and deep knowledge of the markets and has a first-hand appreciation of the industry drivers, issues and trends affecting their portfolio companies. It also means that Advent understands the potential growth areas of that sector and can spot companies with the potential to grow and develop

This does not mean that Advent will never invest outside the key sectors, but there has to be a good reason to do so. For example, about three years ago Humphrey advised on a deal (or led the deal team on a transaction) with a company based in South Africa which supplied services to the Global Mining Industry. This did not fit the usual sector focus but the opportunity came up and he had a senior contact in the global mining industry. Following an informal conversation with her which established that the

company was a good prospect for investment time and effort was put into finding out more about the company and the sector, using external specialist consultants to provide the necessary information and the deal was done. "I would say about 90% of our investments fall into our sector strategy," says Humphrey. "It just takes us longer to get up to speed where we don't have the sector knowledge but it can be done, especially with input from our Operating Partners."

One of the other key aspects to the Advent investment strategy is the amount of due diligence they undertake before making an investment. This is crucial to understanding every aspect of the business and the potential for top line growth, or cost savings, or expanding into new international markets. It is also important to understand the management team, who have in Humphrey's experience generally welcomed the involvement of Advent. Advent see themselves as a medium term investor, they are not looking for a fast but unsustainable improvement in profitability. They want to explore ways in which to add value to the business over the long term and in doing this, to encourage the incumbent management team to think outside the box and challenge assumptions.

"We will ask them what they have failed to do over the last five years that they should have been doing. Sometimes they have not been doing what might seem sensible because it has not been corporate policy to take that course of action. But once they are no longer part of that corporate, they can make the most of previously unrealised opportunities. That thought process is liberating and energising for the management.

"For example, very often non-core subsidiaries of companies are not allocated sufficient capital. We are able to allocate capital if it makes sense. But it's not just about capital. If you are a non-core subsidiary then the people at board level are never going to be paying as much attention to you as they are to other parts of the business. As long as the bottom line is performing as they expect it to, they will be happy to just carry on. They have other things to worry about. In those circumstances, companies are effectively orphaned and they typically don't flourish.

"You do sometimes meet resistance from managers who find the change in focus and process threatening. If they have been comfortable in a position for many years, the prospect of this dynamic and exciting new

environment can be unattractive and you can get a kind of passive resistance. When that happens, we work with the CEO to work out what is right for the business. We encourage the CEO to do the economically sensible thing whatever that might be. It could be making changes to the management structure. Quite often it would involve what we call top-grading. For example, if the strategy is to expand into new markets, and the current marketing director does not seem capable of coping with the expanded brief then the CEO could bring in a Group Marketing Director above them, who can handle the extra challenges involved. As far as we are concerned, the important thing is adding value in the long term.

"What I also hear is that public company boards spend a great deal of time on external issues such as quarterly reporting, talking to analysts, worrying about what the analysts will say, are they making the right disclosures etc. This isn't an empirical figure but anecdotally I am told that public company boards could be spending as much as 70% of their time addressing these issues and only 30% of their time really looking at what adds value to the company. Adding value is more or less synonymous with growth. In a private equity backed company the proportions are the other way around. The focus is on adding value and not only that, we are also looking at a longer investment horizon, over five years rather than having to worry about providing figures which will please the analysts every quarter."

As far as the future of private equity in the current economic climate is concerned, Humphrey thinks it is a bit early to be making predictions. "The dust hasn't settled yet," he says. "The industry business model over the past five to ten years has been leveraged buy-outs and right now it is very difficult to get new leverage, so the model will need to change. I think I should emphasise the words 'new leverage' because there are quite a lot of companies of all kinds, privately owned, public companies or private equity owned companies, that already have leverage built in. What that means is that we can, in principle, do deals that are not looking for new leverage, because its already there. What we might do in these circumstances is buy a company and reduce the leverage by putting more equity into it, almost the opposite of what people think private equity as doing. We can do this because we have the funds to invest."

## Another practitioner viewpoint

**Paul Fletcher** is Senior Partner in the London office of Actis and heads up Actis's business activities worldwide. Actis could be regarded as both a young business (it was created in 2004) and an old business in that it was the product of a demerger from the Commonwealth Development Corporation (CDC) formed by the Government after the second world war to deliver capital into the private sector, initially in the British Commonwealth and then more broadly into emerging markets. CDC is still the largest investor but now Actis also has some 100 other investors.

Actis has raised \$7.6 billion and invests this through a classic model of managing ten-year closed-end funds. Paul asserts that this is one of the advantages of this asset class in that when they put the money to work they are patient and long-term in attitude. Actis has three asset classes: private equity, which covers a wide range of sectors; infrastructure, which would be predominantly electricity, power generation and distribution; and real estate, mainly shopping centres and 'Grade A' office buildings. Actis is also a relatively unique business insofar as it is one of the very few private equity firms that are exclusively focussed on the emerging markets. That focus stretches from China through South East Asia, India, Africa and Brazil.



*Paul Fletcher*

Actis has a broad swathe of offices on the ground, in Beijing, Singapore, Kuala Lumpur, Delhi, Mumbai, Lagos, Cairo, Johannesburg, Nairobi, and San Paolo. This enables the firm to be very close to its investments and close to the markets in terms of knowing where there are sensible places to invest. Actis's entire philosophy is to be physically close to its investee companies working with them through the boards and in many other ways, to help its performance.

There is one market in the BRIC economy in which Actis doesn't invest – Russia. This is also an inheritance from CDC. In the early 1990s the CDC had an arrangement with the European Bank for Reconstruction and Development (EBRD) so that EBRD was the principle source of Government finance going into Russia. Accordingly, Actis does not have the same level of local expertise and knowledge it considers to be a prerequisite for investment decisions. So, although Paul is sure that there are good investments to be had in Russia, it is a gap that they are not rushing to fill, particularly as their investors aren't demanding coverage of Russia.

Why is Actis focused on emerging markets? "*I would say that on one level we are unusual in that we don't give ourselves any choice,*" says Paul. "*Emerging markets are our heritage. They are what we know best. We do not give ourselves the option of investing in Spain or Italy or wherever. We were investing in these markets when they were not flavour of the month and we will continue to do so. There is growth in the emerging markets the likes of which are no longer seen, recessions notwithstanding, in developed markets. I am fond of saying that there is a once in lifetime shift of billions of people out of poverty into some semblance of prosperity.*

*"There are dramatic shifts of spending going on in the emerging markets, the emergence of massive domestic demands for staple goods, be it toothpaste or be it mobile phones, which is creating a very attractive investment environment. There is also the fact that the emerging markets are the home to a low cost labour environment so, again recession notwithstanding, it is the location for manufacturing on a grand scale. And of course the emerging markets, Africa in particular, are home to a significant amount of global natural resources. Finally, the emerging markets have got a huge and continuing demand for infrastructure – so you begin to pile these together and you realise that there really is a very interesting investment opportunity."*

*"I am often asked about the risk of investing in the emerging markets. People talk about country risk, they talk about foreign exchange risk, they talk about legal risk and they talk about regulatory risk. The two risks which I think are of pre-eminent importance are management and governance. If you don't have good management there is no chance that you are going to get a high performing company and clearly if we are working in markets that sometimes have a skill shortage of good management, we are often involved in helping build up management teams. You are also almost certainly going to find yourself in difficulty if you do not have a decently functioning board and governance environment. We will often find ourselves investing in companies where it is the intention to put that into place and we help them to do that, as well as investing in companies that already have excellent governance and management."*

Another risk which is often talked about in relation to emerging markets is corruption. *"The fact that corruption is systemic in some of the markets in which we invest, does not mean that it is all-pervasive and that there are not businesses that operate very ethically,"* he says. *"We take inordinate trouble to screen our investments so that they comply with the high standards of a business like ours that manages other people's money and runs a zero tolerance on corruption. Would I put my hand on my heart and say that I don't have a business that in some way or at some time manages to get a licence at the port to clear goods? I am not sure about that. Have we found businesses where we have got it wrong and that the owners have stolen money from us? Yes – but very rarely. I think the reverse is true – people want us to invest in their business in order to give them the stamp of approval. That they are running a transparent set of books; they are running a board that is working to international standards so that they can grow and over time raise capital not only domestically but also internationally. I come back to my two key risks, if you get good governance and good management then everything else will follow."*

Paul is reasonably bullish about the future for private equity in emerging markets. *"We are in a period of extraordinary change and if you are going to be playing in the broad asset management world, I think I would prefer to be investing money in the emerging markets, for the reasons I have already mentioned, than I would elsewhere. I would prefer to*

*be involved in private equity which means that I have money which is committed to me for ten years which then gives me the time and patience to work with businesses through these difficult times.*

*"Banks are withdrawing debt and I think that, broadly, global liquidity is going to reduce and that private equity will become an increasingly important source of capital for the emerging markets. Over the last few years, we have been competing with an awful lot of other liquidity that has been available. Borrowing a lot of money or raising money through an IPO on a public market are options that I think are going to diminish. So I am reasonably bullish although it is going to be very difficult period over the next 12 to 18 months."*

## Book review

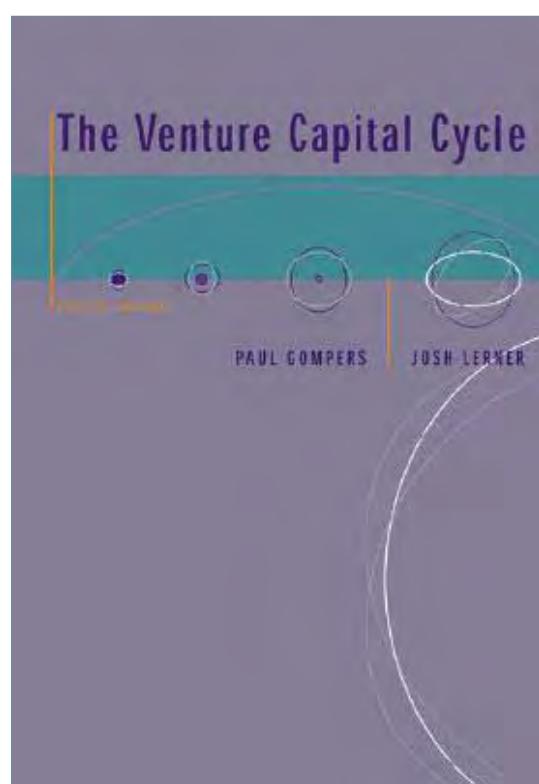
### **The Venture Capital Cycle**

by Paul Gompers and Josh Lerner

Published by MIT press,

ISBN 978-0-262-57238-5 £23.95 / \$36

(see [www.ecgi.org/books](http://www.ecgi.org/books))



This book provides an accessible and comprehensive overview of the venture capital industry. Between them the two authors have fifteen years of research into the form and function of venture capital firms, they examine the fund-raising, investing, and exit stages of venture capitalists.

They consider the nature and history of venture capital and challenge what they consider to be common misperceptions about the role of venture capitalists, particularly the assertion that venture capitalists are purely passive financiers who are unlikely to add much value to young firms, apart from the actual money. They also disagree with the perception that the role of a venture capitalist can be easily duplicated by another kind of institution without the venture capitalist fund's checks and balances (see below) and its understanding of the potential pitfalls which may arise.

Three key themes run through the book. The first is the information and incentive problems that venture capitalists must overcome. Venture investors typically concentrate in industries with a great deal of uncertainty where there are information gaps between investors and the entrepreneurs and where the firms typically would have substantial intangible assets that are difficult to value and which may be impossible to resell if the firm fails. The book explains the novel checks and balances that the venture capital industry has developed to ensure that incentives are properly aligned and to increase the possibility of success.

The second theme is the inter-relatedness of each cycle of the venture capital process. This cycle starts with the raising of a venture fund, proceeding through the investment in, monitoring of and adding of value to firms, continuing as the venture capitalist exits ►

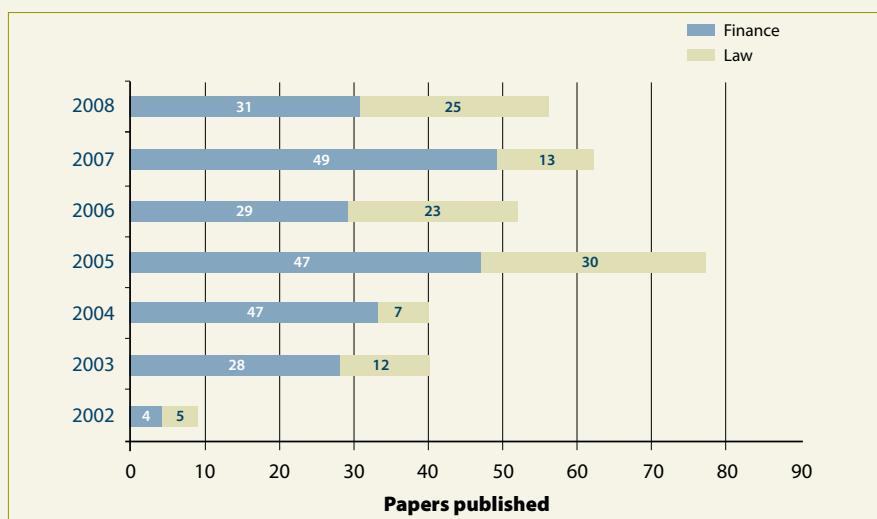
## Working papers in the ECGI Finance and Law series

Both series started in 2002, since when (by December 2008), some 336 papers have been published, 221 in the Finance series and 115 in the Law series.

The papers can be downloaded free of charge from the Social Science Research Network's Financial and Legal Research Institutes Papers Series via the ECGI website.

Two editorial boards, chaired by Paolo Fulghieri, Professor of Finance at the University of North Carolina (Finance) and Guido Ferrarini, Professor of Law at the University of Genova (Law), scrutinise papers from ECGI Fellows and Research Associates for inclusion in the two paper series.

*Further details can be found on the ECGI website at [www.ecgi.org/wp/index.php](http://www.ecgi.org/wp/index.php)*



successful deals and returns the capital to investors before starting the whole process again raising more funds. In order to understand the industry, argue the authors, it is necessary to understand every part of this cycle.

Finally they look at how slowly the venture capital industry adjusts to shifts in the supply of capital or the demand for financing. Because venture funds make long-run, illiquid investments, the funds they secure from their investors can be for periods a decade or more so the supply of venture capital does not adjust quickly to changes in investment opportunities, as compared to mutual or hedge funds for example.

The book suggests, more generally, that the venture capital market represents a particularly refined, if still evolving, solution to the difficult problems associated with financing young firms. Understanding the approaches developed by these investors, as well as the common problems that the investments face can be useful to a wider market, from corporations who want to encourage internal entrepreneurship to policy makers wishing to promote greater innovation and economic development through start-up companies.



The ECGI is an international scientific non-profit association that provides a forum for debate and dialogue between academics, legislators and practitioners, focusing on major corporate governance issues and thereby promoting best practice.

The Institute's primary role is to undertake, commission and disseminate research on corporate governance. Based upon impartial and objective research and the collective knowledge and wisdom of its members, the ECGI can advise on the formulation of corporate governance policy and the development of best practice and undertake any other activity that will improve understanding and exercise of corporate governance.

**ECGI Website:** [www.ecgi.org](http://www.ecgi.org)

## Earlier editions of the Newsletter

Previously published newsletters have covered the following topics

### **Corporate Takeover**

VOLUME 1/SPRING 2006

### **Controlling Shareholders**

VOLUME 2/SUMMER 2006

### **Effective Boards**

VOLUME 3/WINTER 2006

### **Hedge Funds and Activism**

VOLUME 4/SPRING & SUMMER 2007

### **Capital Market Competitiveness**

VOLUME 5/WINTER 2007

These can be viewed on the ECGI website at [www.ecgi.org/research](http://www.ecgi.org/research).

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