

Does Private Equity Ownership Drive Company Performance?



WSI Summary Findings

- To what extent do private equity companies use financial engineering to extract value from their portfolio?
- Will the credit crunch affect the way in which private equity companies manage their portfolio?
- Do private equity-run companies perform better than more traditional management structures?

This report contains information obtained from primary and secondary market research conducted by White Space Insight



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by
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Fund Performance

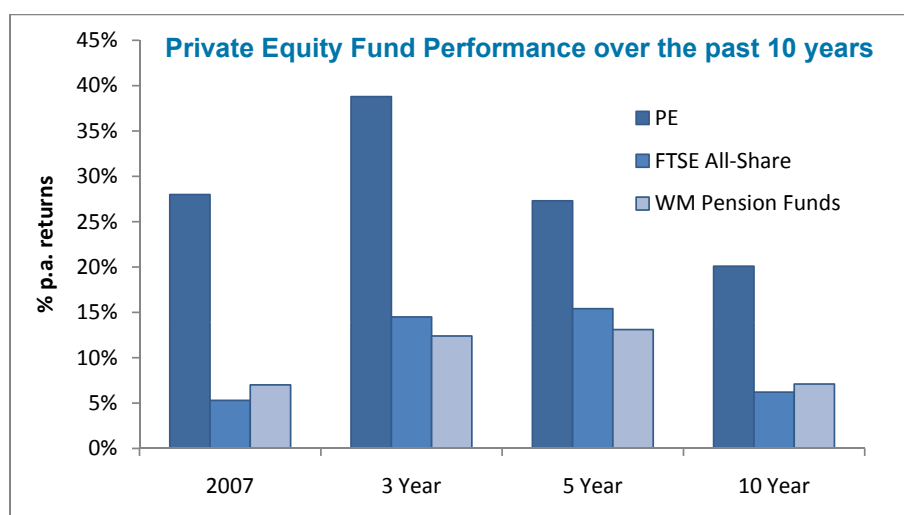
The recent publishing of the British Venture Capital Association's (BVCA) 'Performance Measurement Survey 2007' demonstrated that private equity funds can, and often do offer investors very reasonable returns. Annual total private equity returns greater than 13%¹ for the past ten years have meant that PE has far and away outperformed Total UK Pension Assets and all FTSE indices. The biggest winners have been the large management buyout funds (MBOs) with the weakest results coming from early stage funds.

"The spectacular returns generated by some private equity houses over the past half dozen years have been derived from three sources. High leverage, rising asset prices, and a business model that cuts out the agency problem inherent in listed companies, by aligning exactly the interests of owners and managers" Richard Lambert, Director-General CBI²

All three of these have been key ingredients in generating strong returns on investment. However, opponents to private equity claim that these are often used with little or no regard to the company's long term future, and can ultimately leave the portfolio company worse off than if traditional ownership and management techniques were employed.

Agency Problem

This is a conflict of interest arising between shareholders and management because of differing goals; shareholders want to maximise the company share price and dividends yielded whereas management want to maximise personal returns, which for example can result in an inefficient use of capital to meet quarterly or annual report deadlines in order to secure bonuses



Source: Performance Measurement Survey Summary Results 2007 [19/05/2008] BVCA

1 BVCA: Performance Measurement Survey Summary Results 2007

2 CBI: Private Equity Must Demonstrate Its Business Model Can Deliver in Changed Economic Times [23/04/2008] Richard Lambert, Director-General CBI

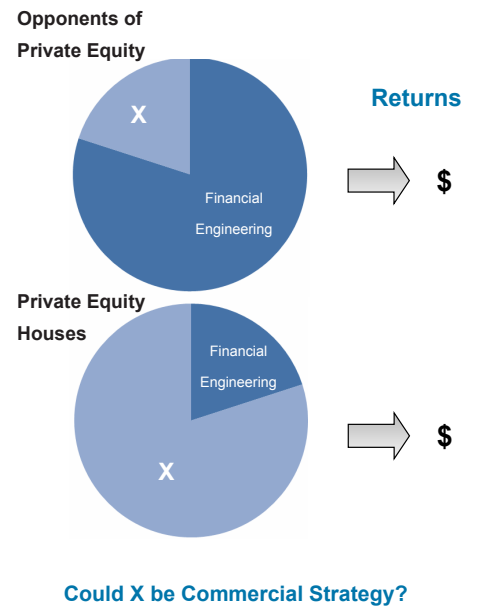
In the past opinions on private equity have often been jaded; a particularly obvious example being when leading German Social Democrat Franz Müntefering famously called private equity houses 'locusts'. The metaphor alluding to his perception that PE houses were frequently in it for the short haul, exiting the deal after the portfolio company had been 'harvested' for profits by using techniques such as financial engineering and labour cuts. Is this true or do private equity houses actually add value in the long term?

Locusts

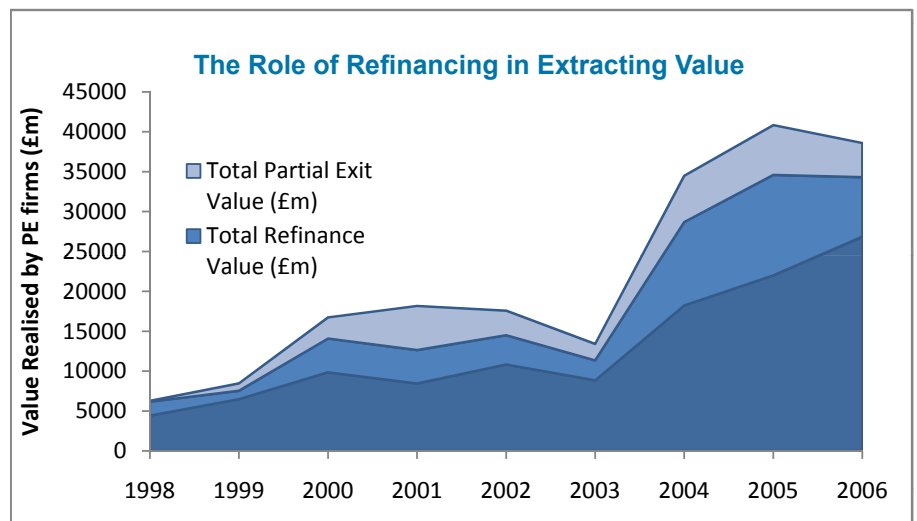
In general, *"Few private equity deals can be described as involving the flipping of transactions within a short period of time following the buyout"* and the average time to exit for UK buy-outs/ins seems to be increasing, according to a report by CMBOR; suggesting that at least for these types of deals the private equity companies are increasingly viewing their investment as longer term. Permira partner Charles Sherwood points out that *"Financial engineering is well understood and it is available to everyone in the market. If it was that simple, most private equity firms would deliver similar returns. But in fact, returns vary enormously"*².

The European Private Equity and Venture Capital association has conducted research that shows that although in the ten years leading up to March 2007, European Buy-Out funds produced an annual average return of 11%, the median was 3%. Since private equity companies should all have similar access to financing techniques, what is the factor causing the disparity between returns? Could it be the difference in quality of commercial strategy employed by competing private equity houses? This is the view held by Mr. Sherwood *"It [good returns] has to depend on delivering some form of value-added [effect on a company] that is not easily understood by everyone... Debt is important, but only in so far as it magnifies value that is created by other means"*.

The Polarised Views on Value Extraction by Private Equity



However, probing further into deal mechanics seems to indicate that financial engineering continues to play a significant part of the total value realised for UK buy outs/ins by PE firms. The contribution of refinancing³ as a percentage of total value realized by PE firms, doubled from 1997-2006. The purchase of Debenhams, and exit onto the stock market within 30 months is a particularly striking example of financial engineering.



Source: Private Equity and Buy-outs: Jobs, Leverage, Longevity and Sell-offs [2007] White, Burrows, Ball, Scholes (CMBOR)

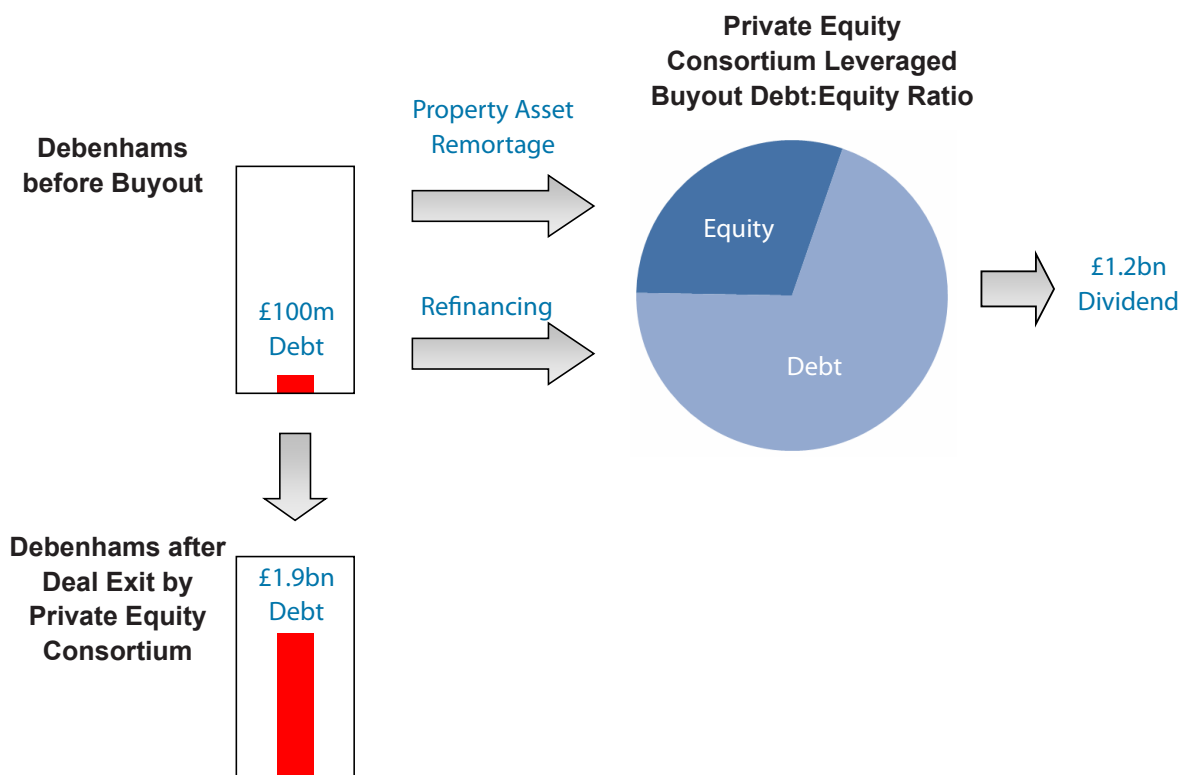
1 Private Equity and Buy-outs: Jobs, Leverage, Longevity and Sell-offs [2007] White, Burrows, Ball, Scholes (CMBOR)

2 BVCA: Private Equity in the First 25 Years

3 The practice of an acquired business borrowing money which is then used to pay dividends to the fund, or sale and leaseback of property assets with the proceeds from the sale being used as a dividend for the PE fund

Case Study

A consortium of private equity firms, CVC, Texas Pacific and Merrill Lynch Private equity bought the department store chain in 2003 for £2bn (£1.4bn debt; £600m equity), with Debenhams having only £100m debt at the time. Soon after the deal was completed property assets were separated from the operating business and remortgaged to release cash to help pay for the buyout. The business was also refinanced twice increasing debt to £1.9bn. Overall this allowed £1.2bn to be taken out of Debenhams and returned to the consortium as a 'special dividend' worth twice the original stake¹.



Cleaning Ladies

The fact that these types of techniques are used is unsurprising given the way in which general partners of private equity funds are remunerated (typically receiving a 20% share of the profit realised from the sale of a portfolio company, after a certain threshold has been reached – much of which could be masked under Capital Gains Tax). Nicolas Ferguson, chairman of investment group SVG previously said, talking to the Daily Mail, that he had not seen a justified reason for why private equity partners could “pay less tax than a cleaning lady”. Since then the CGT laws have been changed to a flat rate of 18% rather than the tapered relief value of 10% in the past, however 18% is still small when compared to the upper income bracket of 40%.

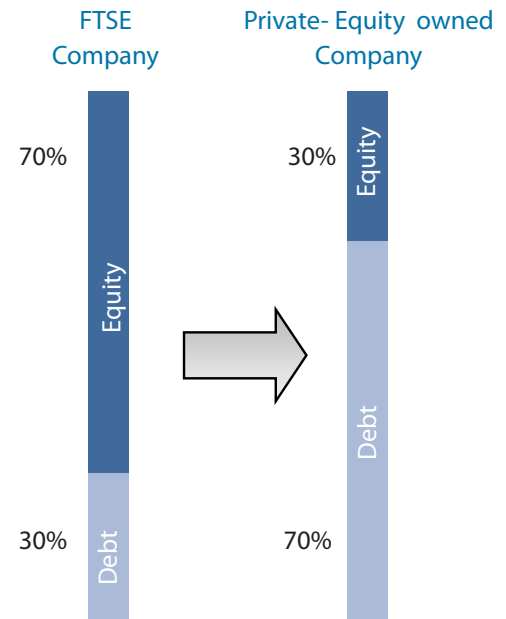
¹ Private equity and the culture of value extraction: Julie Froud and Karel Williams for CRESC, The University of Manchester

Leverage remains the most important financing strategy for delivering value to equity sponsors; allowing minimum equity investment and taking advantage of the tax deductibility of interest payments on debt.

In the UK it is not unusual for a FTSE company with 30% debt, 70% equity to shift to a private structure with 30% equity and 70% debt, although more commonly the structure is a trade off between these two extremes. Simulations have shown that re-leveraging all FTSE 100 companies from 30:70 to 70:30 debt to equity ratios has the effect of increasing the volatility of returns on equity; with better returns in cyclic upswings and worse returns at the bottom of the worst economic slowdowns.

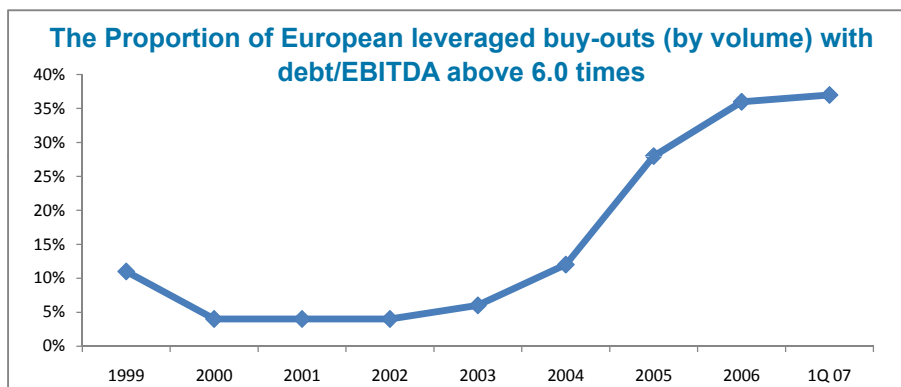
Effective use of debt can increase returns on equity although it is important to stress that it exposes companies to macroeconomic fluctuations, and should be used in moderation. (Remember the hedge funds that went into liquidation in the midst of the credit crunch). It is unclear whether the authorities will address the issue of thin capitalisation (essentially disguising debt as equity), and other favourable accounting strategies used by private equity houses, although the credit crisis seems set to reduce the degree of gearing utilised in the short term.

Is Leverage All Bad?



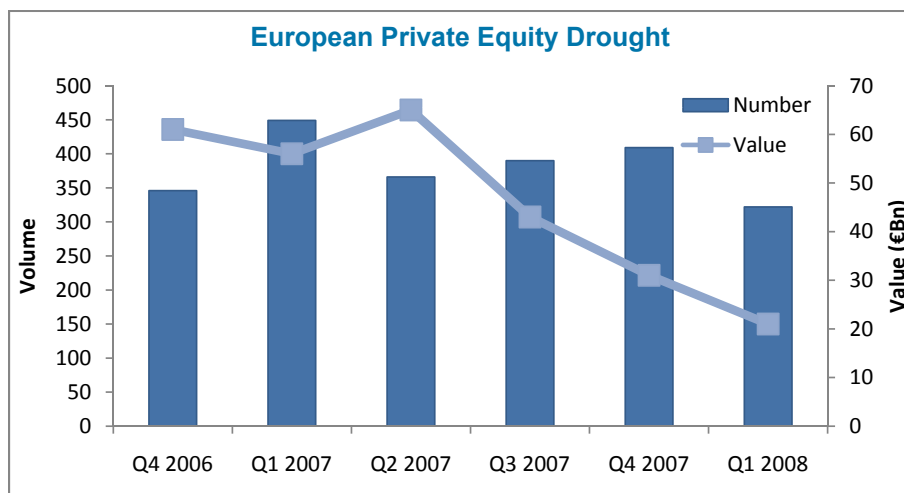
The degree of leverage used in buy-outs soared in the buoyant economic conditions leading up to April 2007 at which point, *“Maximum debt levels for European LBOs [leveraged buy-outs] [were] consistently above seven or eight times earnings”* according to the Stability Report by the Bank of England.

Positives from the Credit Crunch



Source: House of Commons Treasury Committee Private equity Tenth Report of Session 2006–07 Volume I

Gearing has certainly fallen since the onset of the global credit crisis, with the number and value of private equity deals plummeting in Q1 2008 driven by, *“A lack of availability of debt financing for buyout transactions”*.



Source: Unquote Private Equity Barometer Q1 2008

Although in general the credit crunch is having an adverse effect on businesses, it could well have a positive effect on the private equity house strategy employed to run their portfolio. Going forward this should lead to an increased focus on commercial strategy and its associated due diligence. This opinion is seconded by Jon Moulton of Alchemy Partners, *“Big funds have made a lot of money out of rising debt multiples. Looking forward, we are going to see an increase in due diligence accompanied by a reduction in prices, a reduction in leverage and a reduction in returns”*. But currently what effects does private equity involvement have on their portfolio?

Management and Strategy

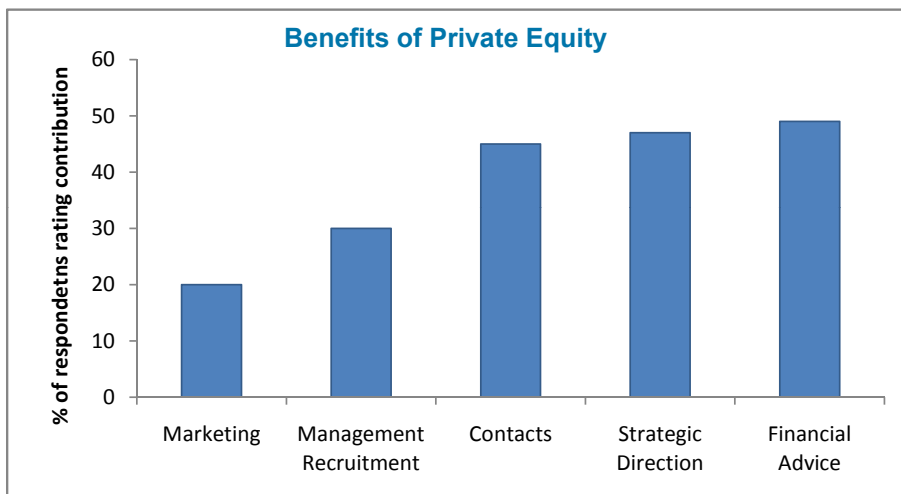
The range of management styles employed by PE companies is as diverse as the portfolio companies themselves. Whereas some PE investors use a ‘hands on’ approach; seconding a partner to the board; others are content to analyse the financial performance of companies – reacting only to weak results.

The harshest critics accuse PE owners of ‘asset-stripping’ and ‘savage job cuts’ citing examples like the AA², where 10,000 jobs have been cut since Permira took over the company in 2004. While there seems to be evidence of the latter in some PE deals, it is not fair to tarnish all private equity investors with the same brush. For deals structured as MBOs, a report by the Centre for Management Buyout Research claims that after six years, employment is 36% greater than for the year before the deal. This suggesting that in the case of MBOs at least, private equity involvement could lead to quite strong business growth.

1 Unquote Private Equity Barometer Q1 2008

2 news.bbc.co.uk – The AA: rescue or wrong turn?

There is significant evidence that private equity houses, in general, are beneficial for the companies they acquire. The BVCA has highlighted that in a survey³ 91% of respondents said that without private equity their “business would not have existed at all or would have developed less rapidly”. In the same report individuals found that private equity investors contributed in other ways than financing; with 47% believing that PE companies had helped them with strategic direction.



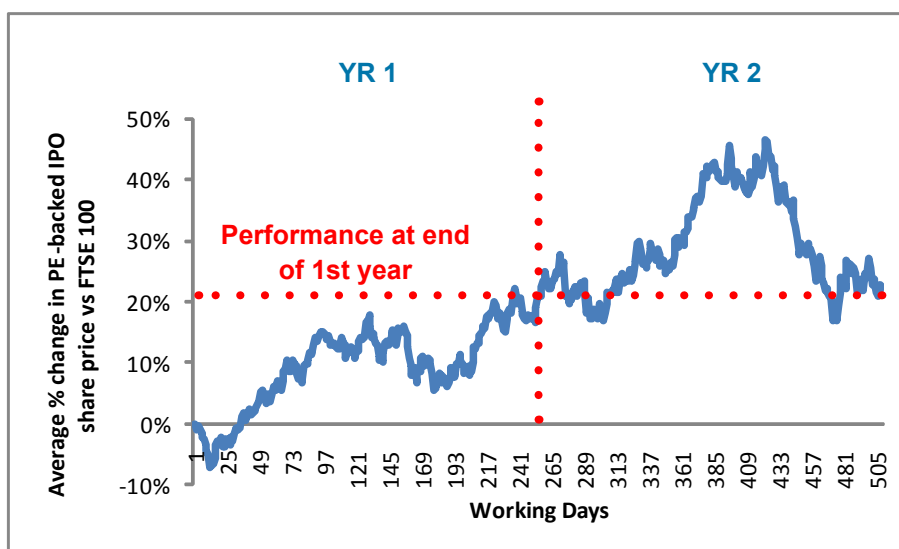
Source: The Economic Impact of Private Equity in the UK

Surveys and employment measures are reasonably good qualitative indicators that private equity involvement is beneficial to a portfolio company. In order to gain a more quantitative insight into the benefit of private equity involvement WSI looked at the performance of private equity backed IPOs on the stock market.

3 BVCA: The Economic Impact of Private Equity in the UK

Better Sustained Growth?

One of the potential deal exits for a private equity house is the listing of the portfolio company on a public stock exchange with subsequent share performance sometimes used as a measure of business growth. Previously the strong 1st year share performance of PE-backed companies has been stressed explicitly in several reports. WSI conducted analysis comparing the 2 year share price performance of 6 PE-backed IPOs (on the LSE over the period 2004-2006) vs. the FTSE 100 index. Although the sample size is not statistically significant, the methodology and results could indicate that analysing 1st year after-IPO performance might not be representative of underlying company performance.



It is undisputed that PE-backed IPOs outperform the market during the 1st year after listing – our analysis of 6 PE-backed IPOs shows out performance of the market greater than 20%, which echoes results from similar reports. However, it is uncertain that these strong results are necessarily a result of faster continued growth in private equity portfolio companies, or simply due to the experience of a private equity backer of achieving a low value at listing. Similarly companies often have lock in agreements with their private equity backers; ensuring they remain shareholders until a certain date after listing – usually a year to 18 months or until the first AGM. The ‘halo effect’ surrounding the involvement of a private equity company may spur on investment in the short term and be the cause of share out-performance over the first year or 18 months.

This hypothesis is reflected in the sample data with out-performance over the first 18 months, then followed by a market correction. The sample size is not statistically significant and hence it raises more questions than it answers. However these results cast doubt over whether private equity companies perform better in the mid-term. More extensive analysis with a larger range of companies over a longer time scale is needed in order to come to a conclusion as to whether PE-backed companies actually outperform the market.

Where fund performance consistently out competes most other asset classes it is easy to be cynical; to call all private equity houses modern day barbarians who pillage companies for all their worth, leaving behind useless shells. In fact the range of views on private equity is as varied as the types of private equity companies that exist. Financial engineering exists, but usually only as a means to accentuate the returns generated from business growth.

Conclusion

There are certainly benefits to private equity outside of raising capital as supported by the results of the aforementioned survey by the BVCA and the employment growth seen in MBOs. On the face of it this is promising for private equity, although there is more work to be done in order to quantify the level of benefit achieved for a company going private, and measure the gap between perceived performance and actual.