Private equity's halcyon days are not yet threatened

By Philip Purcell
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The $45bn (£23bn) buyout of TXU Corporation, the US energy group, by Kohlberg Kravis Roberts and Texas Pacific Group raises a number of questions. The most obvious, given the nature of markets, is whether this exuberance signals an imminent downturn for private equity.

The answer is: not yet. The boom has been driven by increasing amounts of new money seeking superior performance. According to Thomson Financial, private equity net returns outperformed the S&P 500 19 per cent to 9.7 per cent for the 12 months to last September and 14 per cent to 9.7 per cent for the past 20 years. The flow of new money into private equity will continue as investors are attracted by two decades of out-performance.

Will private equity continue to outperform public markets? Is this good for the economy? In both cases the answer is yes, because public markets are failing to allocate capital efficiently. This is not a bubble but a cyclical trend that is likely to end only as public companies become more efficient. At first glance, public markets appear to be less costly for investors because of private equity's notoriously high "friction costs" - the various fees, operating costs and inefficiencies that reduce return on investment.

These costs start with a 2 per cent fee on committed capital (about 4 per cent on average invested capital) and 20 per cent of the profits (or 5 per cent if returns are 25 per cent). Acquisition fees, disposal fees, fees charged to the companies and legal fees probably add 2 per cent, bringing total friction costs to about 11 per cent a year. But in profitable markets the greater leverage of private equity funds in an environment of plentiful, low-cost debt acts as a kind of steroid to returns that can offset half this amount, resulting in net friction costs of 5 per cent a year.

Investors in public companies pay just 1 per cent to 2 per cent in brokerage, mutual fund or money management fees. But the total friction costs are often significantly higher than 5 per cent because of other, less visible, costs such as increasingly responsive boards, greater compliance costs, litigation costs and the loss of management talent to private companies.

Public boards are constructed to reflect society and encourage independence, with the result that fewer board members have business experience. Private board members, in contrast, are usually chosen for their ability to increase revenues, margins and profits. Public company chief executives must also respond to all those who want a say in the management of their companies, from shareholder advocates to regulators. This means less focus on profitability, market share and long-term strategy. Public companies, for excellent reasons, must also comply with securities laws, Securities and Exchange Commission mandates and Sarbanes-Oxley, which require expensive accountants, financiers, lawyers and systems engineers.

The plaintiff bar targets public companies because they are more susceptible to public relations pressures that can affect their stock price. So they are often willing to settle. Private companies are more likely to fight frivolous suits.

Private equity has begun to attract the best operating managers from many industries. These managers can participate directly in creating value, potentially earning multiples of what they were getting at public companies. They can focus their talents and energies on building a business rather than dealing with bureaucracies.

What about the impact of private equity on the economy? The focus of private equity firms is on the internal rate of return, which forces capital to high return investments. Private equity firms try to reduce excess capital - capital tied up in inventory, payables, receivables and other forms of working capital. When a portfolio company is sold, the capital is reallocated to opportunities with higher returns. The result is rapid reduction of capital in mature industries and increased investment in growing industries. Public companies must heed the demands of a wide range of stakeholders, employees, management, division managers, lenders, unions and politicians - most of whom have a stake in the current allocation of capital.

Taking companies private spurs innovation. This may seem paradoxical, given private equity's reputation for "flipping", or sale for short-term profit. It is true that private equity firms have a near obsession with trimming costs and tidying up balance sheets of portfolio companies so that they can eventually be sold. But that can take five years or so, which provides breathing room to consider promising innovations. Public companies, on the other hand, face relentless pressure to meet quarterly earnings estimates.

The halcyon days for private equity will eventually end. The constraints on the public model will ease. The returns in private equity and those in the public markets will begin to converge. Increased regulation of private equity or a radical turn in the credit cycle could also affect the current dynamic. Until then, private equity firms will continue to offer a classic capitalist response to a public market that is failing to allocate capital efficiently.

The writer is president of Continental Investors. He is a former chairman and chief executive of Morgan Stanley