A GUIDE TO PRIVATE EQUITY

July 2021

What is "private equity"? Technically, it just means ownership of a company by a private party, instead of by shareholders who can buy and sell their shares in the public stock market. Venture capital, for instance, is a form of private equity. Buying your friend's restaurant because he wants to retire would be private equity.

But when people say "private equity" (PE), they are usually talking about leveraged buyouts. That's when a group of partners put in some money of their own and then borrow a lot more, and use the total amount to take over a company. The goal is to pocket the company's profits while also making it more valuable, then resell it to someone else—the profits plus the sale price can be used to pay back what was borrowed at the beginning, and hopefully there's a lot left over for the partners themselves.

Using this strategy, partners can use relatively little of their own money to buy very large companies and, if they sell for more than they paid, generate huge profits relative to what they put in. Partners who want to use this strategy repeatedly create PE firms, like Bain Capital and Blackstone, which raise even more money from limited partners (LPs) who also put up money but have no say in how the target companies are bought or run. Most often, these LPs are large institutional investors like pensions, endowments, and sovereign wealth funds. The PE firms charge these LPs large fees to manage the money and do the deals, ensuring that the PE firms profit regardless of how their investments perform.

In the industry's early years (the 1980s–90s), PE firms achieved extraordinary returns on their investments. A story emerged that they were savvy managers of the companies they bought and created enormous value not only for themselves but for the broader economy. But as more and more firms and investors piled into the industry, the bargains disappeared, and so did the results. It's been more than a decade since LPs saw better returns than they would have achieved by just putting money in a basic public index fund. PE firms eager to justify their existence are placing ever-riskier bets at ever-higher prices. More often than not, they now sell their companies to each other, or even to themselves. This is unlikely to end well, either for their investors (often the taxpayers behind public pension funds) or workers at the targeted companies. The PE firms, of course, will still collect their fees.

"The more leveraged takeovers and buyouts today, the more bankruptcies tomorrow."

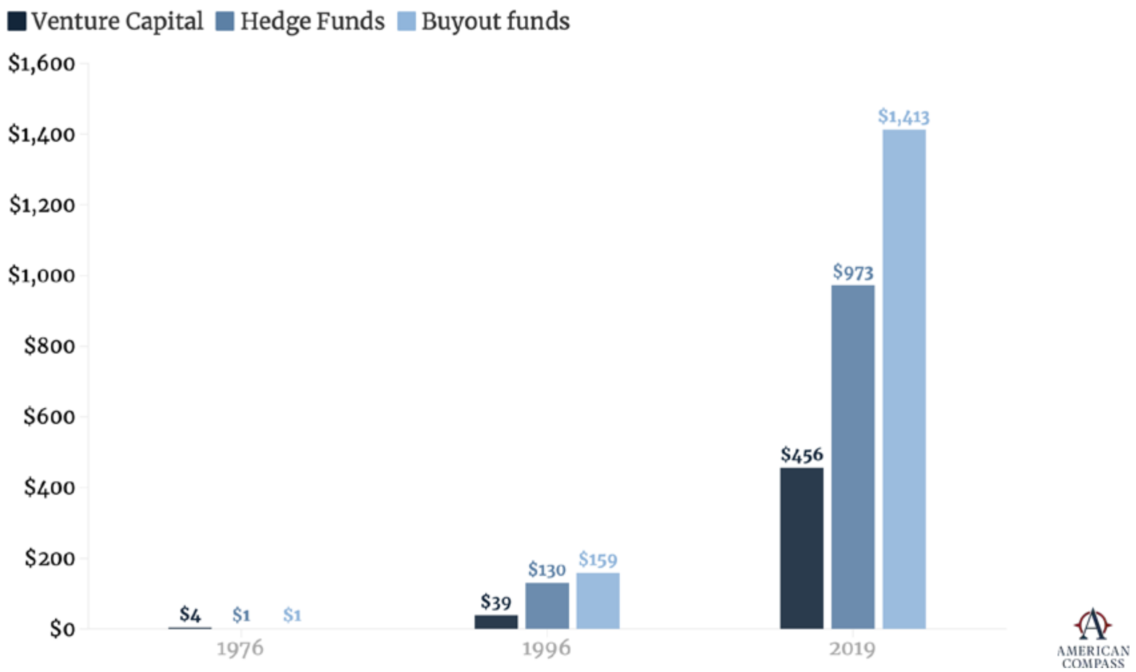
—John Shad, SEC Chairman, 1984

The Private-Equity Explosion

Leveraged buyouts barely existed in the 1970s. In 1976, investors had put less than $1 billion into them. Venture capital was at least four times bigger. By the 1990s, buyout funds held $150 billion. In 2019, the total reached $1.4 trillion invested, three times larger than the total for venture capital.

Private Equity Rising

Assets under management of U.S. investors, billions of dollars

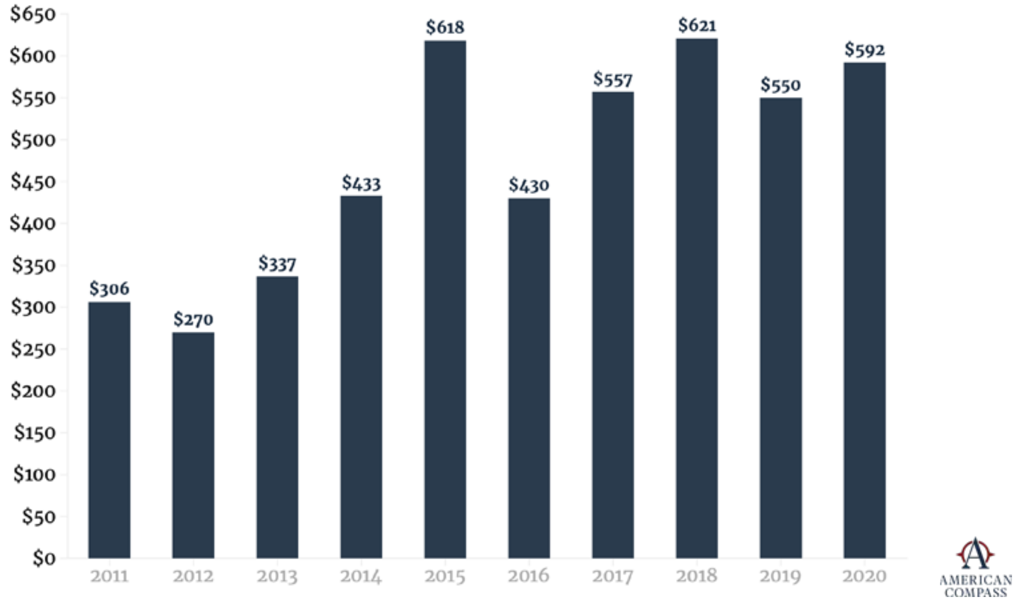


Source: Morgan Stanley

In 1984, *Time* magazine reported breathlessly that, “last year there were 36 [leveraged buyouts] worth $7 billion, compared with only 16 in 1979.” In 2020, there were close to 3,000 deals worth almost $600 billion. While this represented a decade of extraordinary growth, the total was still lower than its level in 2007, when the last financial crisis struck and the industry contracted sharply.

The $600 Billion Pound Gorilla

Global buyout deal value, billions of dollars

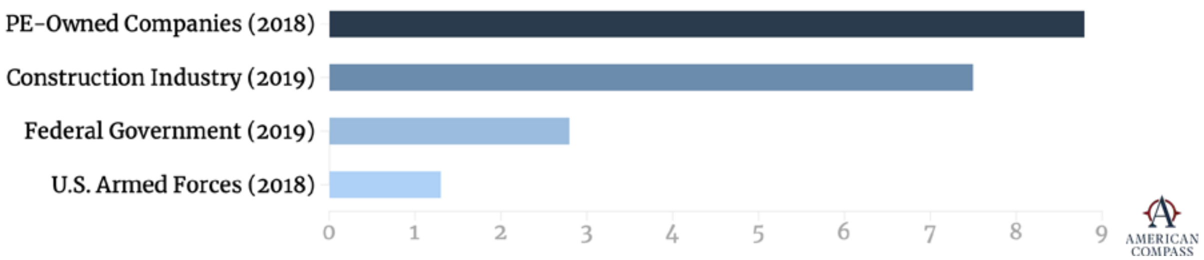


Source: Bain & Company

Companies owned by PE firms now account for about 5% of U.S. GDP and employ nearly 9 million people, a workforce many times larger than the federal government or the active-duty U.S. military, or even the entire construction sector.

American Manpower

Millions of people, by employer

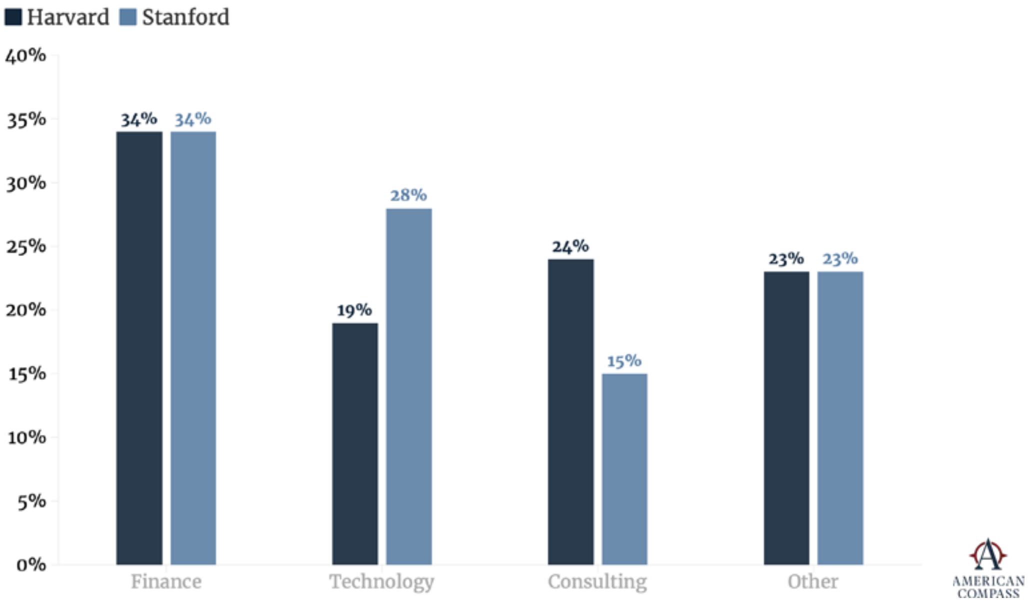


Source: U.S. Bureau of Labor Statistics; Council on Foreign Relations; Ernst & Young
Note: Some private-equity-owned companies are in the construction industry.

The PE firms that make and manage these acquisitions are the most popular landing spots for graduates of the most prestigious business schools. In 2020, more than one-third of the graduating classes at both Harvard and Stanford entered the finance industry and in both cases PE was the top destination therein.

Battle for Talent

Industry share of 2020 MBA graduates



Source: Harvard University; Stanford University

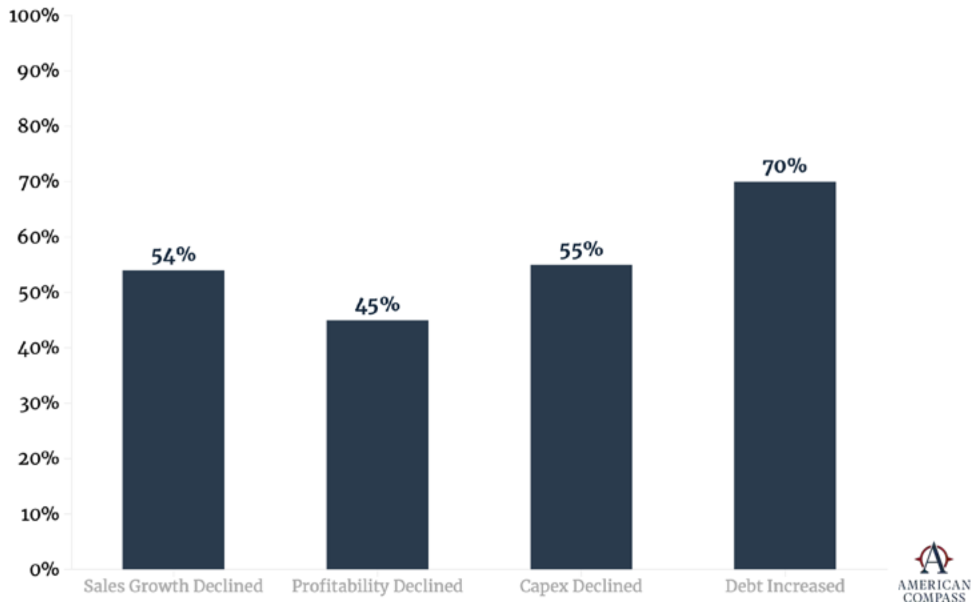
What Are Private-Equity Firms Actually Doing?

PE firms claim that they create economic value and generate profit for investors by managing their acquisitions well, allowing them to sell businesses for more than they paid. But as researchers at the University of Texas concluded bluntly in 2013, "we find little evidence of operating improvements subsequent to a [leveraged buyout]."

Industry veteran Daniel Rasmussen has studied a comprehensive database of 390 PE deals, including most of the largest deals ever done. If the industry's claims were true, wrote Rasmussen, "we should see results in the financials of the portfolio companies, such as accelerated revenue growth, expanded profit margins, and increased capital expenditures. But the reality is that we see none of these things. What we do see is a sharp increase in debt."

What Would You Say You Do Here?

Financial performance of private-equity-controlled businesses



Daniel Rasmussen, *American Affairs*

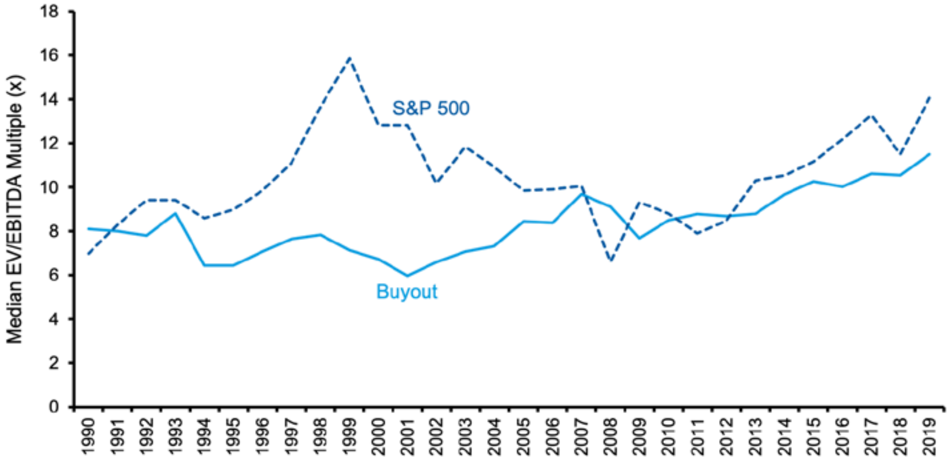
Rather than managing businesses well, the secret to PE's success appears to be the extraordinary bargains that the industry was able to find in its early years. The first PE firms were pursuing novel strategies and faced little competition as they went bargain hunting for undervalued companies.

In the 1990s, a company in the S&P 500 would cost $10 to $15 (the "enterprise value," or EV) for every $1 of operating profit (or EBITDA) it generated. PE firms were buying up companies that cost only $5 to $7 for every $1 of profit. But by the time of the financial crisis in 2008, that gap had vanished.

Bargain Hunting for Big Game

Median EV/EBITDA for U.S. Buyout Deals and S&P 500, 1990–2019

From Mauboussin & Callahan (August 2020)



Source: Exhibit 28 in Michael J. Mauboussin and Dan Callahan, "Public to Private Equity in the United States: A Long-Term Look," Morgan Stanley, August 2020

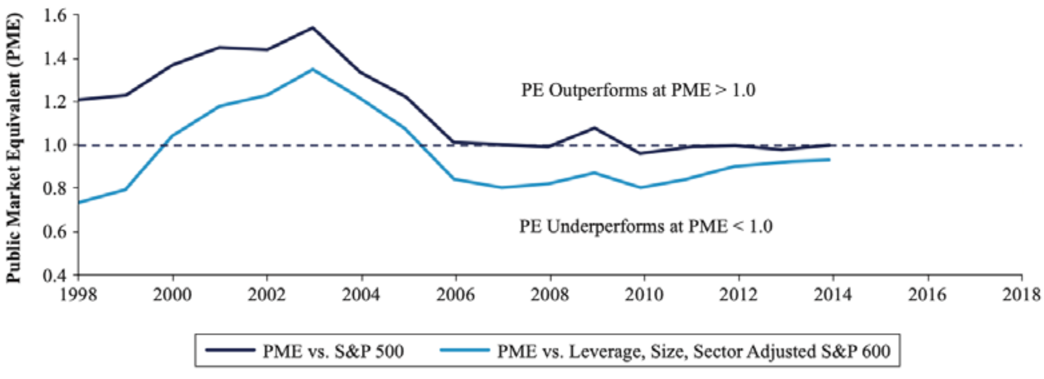
The funds created by PE firms in the 1990s that bought at bargain prices generated enormous returns. "Public Market Equivalent" (PME(is a way to compare the performance of a PE fund to equivalent investments in the public market. A value above 1 means PE is performing better. In the early 2000s, PMEs reached as high as 1.4, representing extraordinary returns for PE investors.

But after 2006, with the bargains gone, PME fell to 1 or even below. PE firms started having to pay the same kinds of prices that investors in the public market paid. And once that happened, their returns started to look just like the public market's too. Investors would have done at least as well simply investing in broad-market index funds.

What Happens When the Music Stops?

The Valuation Gap and Performance Gap Between PE and Public Equities

From Ilmanen, Chandra & McQuinn (Winter 2020)



Source: Exhibit 2 in Antti Ilmanen, Swati Chandra, and Nicholas McQuinn, "Demistifying Illiquid Assets: Expected Returns for Private Equity," Journal of Alternative Investments, Winter 2020

Indeed, study after study now finds that, since the mid-2000s, PE has performed no better for investors than just investing in an index of similar, publicly traded companies. And that's before accounting for the factors that make PE less attractive—all the debt makes it risky, you can't get your money out for a long time, and it's hard to tell how well you're doing along the way. Most analysts say annual PE returns would need to be 3–6% higher than the public market's to be a worthwhile investment. The industry is nowhere close.

> "Using a bottom-up approach, we identify the systematic risks of underlying companies in buyout funds to inform an appropriate risk-adjusted benchmark, which we determine to be a levered size- and sector-adjusted public index. After making these risk adjustmenwts, we find no significant outperformance of buyout fund investments versus the public market equivalent on a dollar-weighted basis."
>
> —Jean-Francois L'her et al., Financial Analysts Journal (2016)

> "Private Equity (PE) funds have returned about the same as public equity indices since at least 2006. … Three large datasets show average net MoMs across all PE funds at 1.55, 1.57 and 1.63. These net [Multiple of Moneys] imply an 11% p.a. return, which matches relevant public equity indices; a result confirmed by PME calculations."
>
> —Ludovic Phalippou, University of Oxford (2020)

> "Since 2009, when the global economy limped out of the worst recession in generations, US public equity returns have essentially matched returns from US buyouts at around 15%."
>
> —Bain & Company (2020)

> "PE's outperformance over public equities has declined, with post-2006 vintages realizing lower outperformance than prior vintages. This is in line with the empirical findings of other studies. Harris et al. (2014, 2016) observed PMEs near 1 after 2006, implying that PE has had no edge over public equity since 2006."
>
> —Antti Illamen et al., AQR (2020)

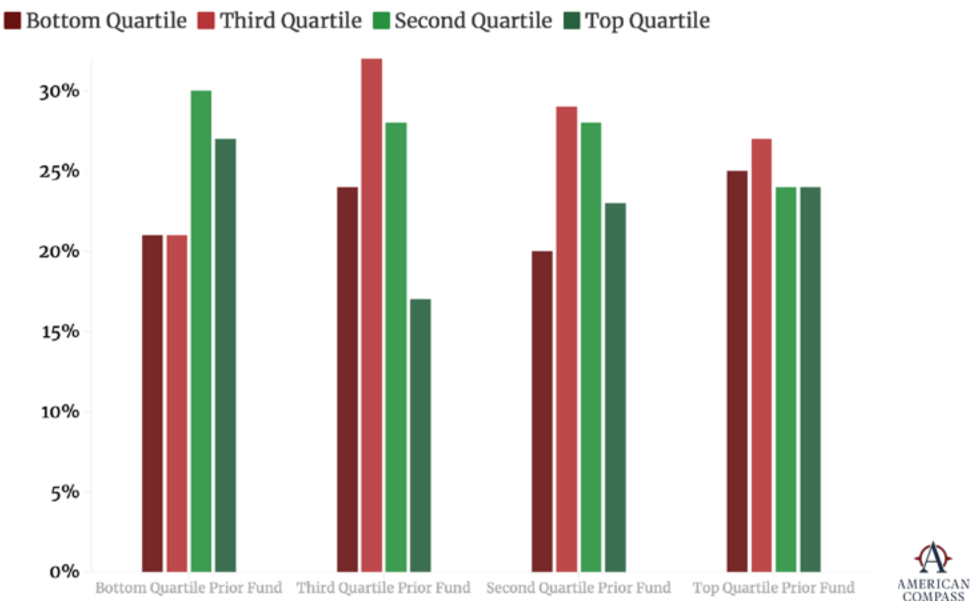
> "How much do PE vehicles deliver to investors, on a risk-adjusted basis? We find negative alpha across the board when we allow for a broad mix of possible factors."
>
> —Arpit Gupta, NYU Stern School of Business (2021)

Performance is not only unimpressive, but also quite random. One could imagine a situation where PE firms overall performed poorly, but the *good* ones really were very good. Analysts study this question of "persistence" by comparing a PE firm's performance with one fund to the performance of its next fund. If high returns were a matter of savvy management, then the firms that delivered a "Top Quartile" fund in one period (meaning performance was in the top quarter for all funds) should be more likely to deliver a Top Quartile fund the next time around.

In PE's early years, such persistence was present. Since 2000, it is not. For a PE firm that has just delivered a Top Quartile fund, its next fund is about equally likely to land in any quartile. If anything, it appears its next fund is likely to perform below average. An investor's best chance of finding a Top or Second Quartile fund would be to go with a PE firm whose last fund was in the *Bottom* Quartile.

Pick a Fund, Any Fund

Quartile of subsequent fund by prior fund quartile, since 2000



Source: Morgan Stanley

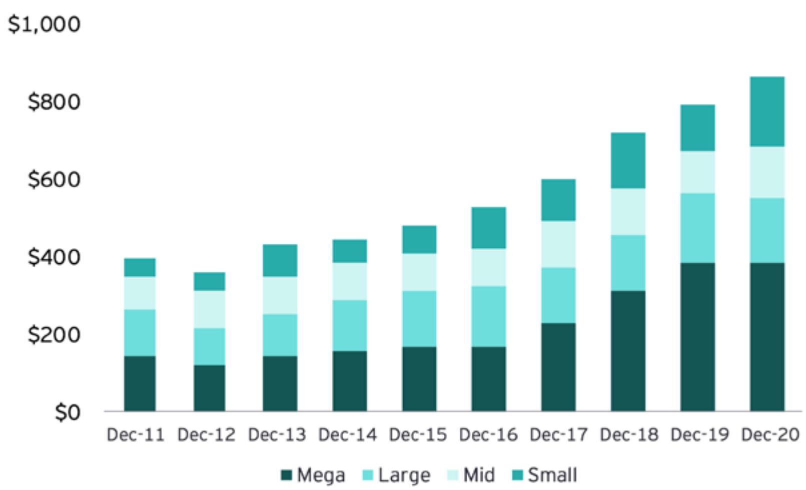
Blowing a Bubble

Despite more than a decade of poor performance, PE firms continue to raise enormous funds to pursue new deals. At the end of 2020, firms were sitting on a record $1 trillion of "dry powder"—money raised but not yet invested. This presents PE firms and their fund managers with enormous pressure to find and do deals, at whatever price necessary.

Burning a Hole in Their Pocket

Dry powder by buyout fund size, billions of dollars

From EY (2020)

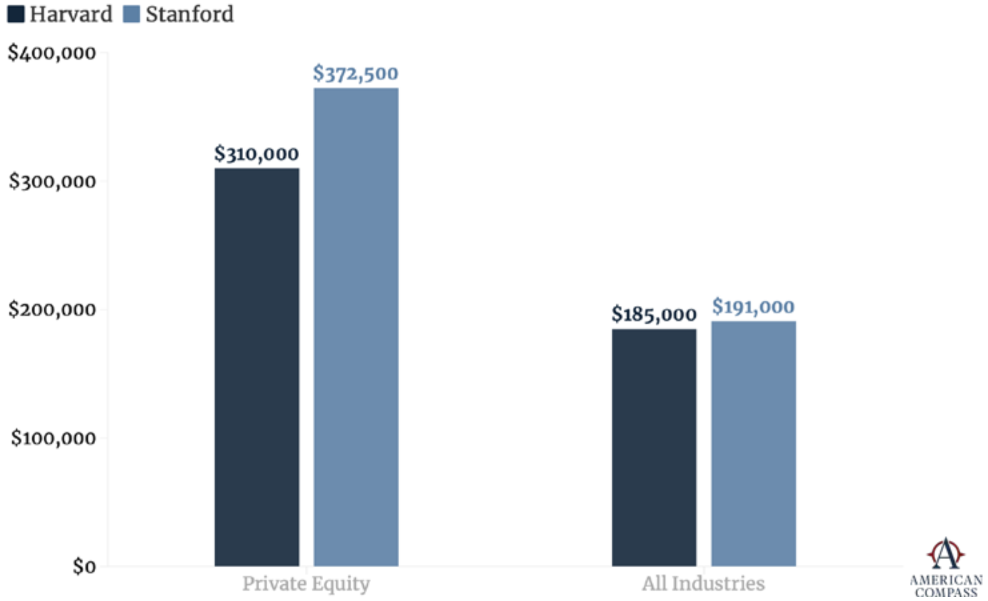


Source: Page 4 in EY, "PE Pulse Q4," 2020

So long as money flows into PE, and investors allow PE firms to charge fees for managing the funds and executing deals (regardless of how those deals perform), the industry will continue to attract top talent with the economy's top compensation. For graduates of both Harvard and Stanford, PE was not only the most popular, but also the highest-paying industry. Freshly minted MBAs could expect compensation of between $300K–$400K in PE, roughly double the average for their fellow graduates in other industries.

Top Guns

Median first-year salary and bonus for 2020 MBA graduates



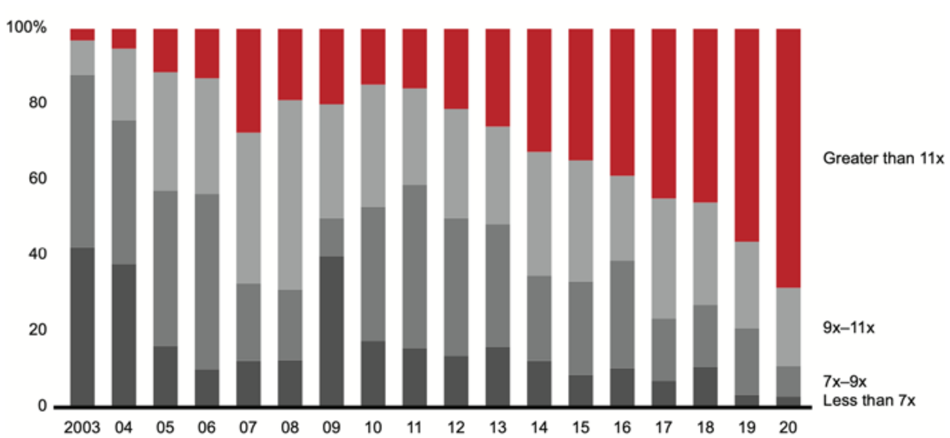
Source: Harvard University; Stanford University
Note: Excludes signing bonuses

With more funds competing for fewer attractive deals, valuations keep going up. Most deals are now done at a valuation more than 11 times a business's underlying profit, while vanishingly few deals are done at valuations below 9 times profit, which used to be the norm.

Paying Whatever It Takes

Average EV/EBITDA purchase price multiple for U.S. buyout deals

From Bain & Company (2021)



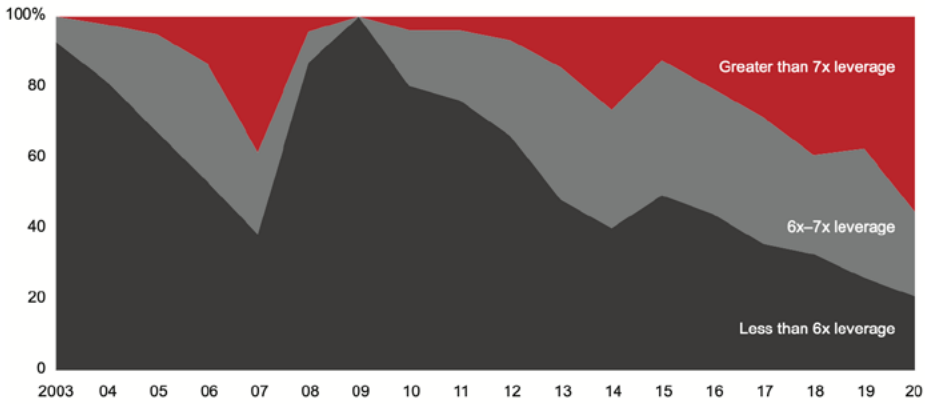
Source: Page 11 in Bain & Company, Global Private Equity Report 2021, p. 11
Note: Includes deals with disclosed purchase price and leverage levels only

To find attractive returns in the face of rising valuations, PE firms keep taking on more and more debt to finance their acquisitions. In 2020, for the first time, most deals used more than $7 of debt for every $1 of profit at the acquired business—a level unheard of in the past.

Living on Borrowed Dimes

Share of U.S. leveraged buyout market, by leverage level

From Bain & Company (2021)



Source: Page 12 in Bain & Company, Global Private Equity Report 2021, p. 12

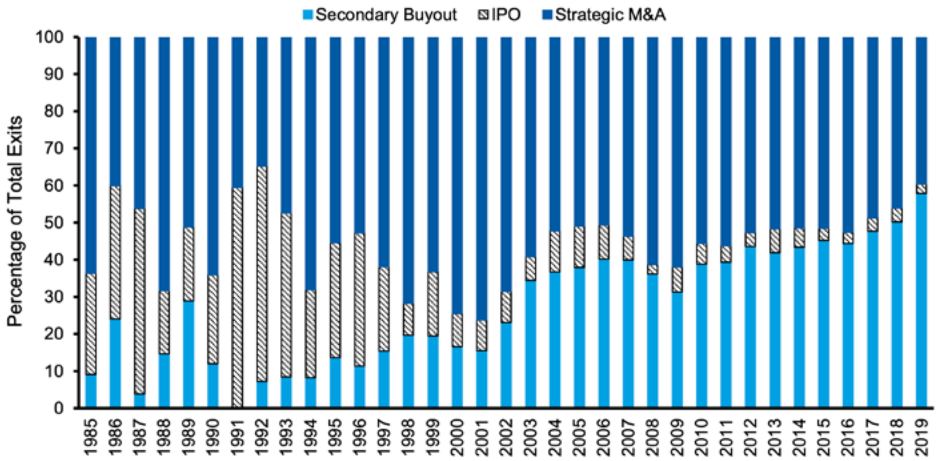
Suspiciously, PE firms are having a harder time than ever selling the companies they've already bought. The most common buyer when a PE firm sells a business is now another PE firm, in what's called a "secondary buyout."

Matters have gone from bad to worse as firms are now raising new funds of their own to buy businesses from their old funds. The traditional term for this behavior is "Ponzi scheme."

Selling in Circles

Exits for U.S. buyouts

From Mauboussin & Callahan (August 2020)



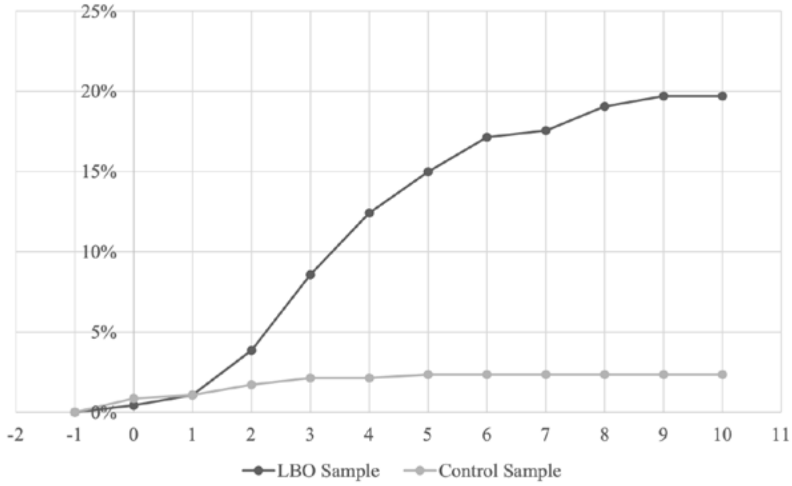
Source: Exhibit 32 in Michael J. Mauboussin and Dan Callahan, "Public to Private Equity in the United States: A Long-Term Look," Morgan Stanley, August 2020

Ultimately, bad PE deals aren't just a problem for investors. The debt that PE firms add to their acquisitions leave the businesses far more susceptible to bankruptcy. A study of more than 400 PE deals found that roughly 20% ended in bankruptcy within 10 years. By contrast, in a control group of 400 equivalent companies that were not acquired, only 2% ended in bankruptcy over the same timeframe.

A Bankrupt Model

Comparison of bankruptcy rates

From Ayash & Rastad (2019)



Source: Brian Ayash & Mahdi Rastad, Leveraged Buyouts and Financial Distress, California Polytechnic State University, July 2019
Note: X-axis represents number of years after private-equity acquisition.

Conclusion

PE's defenders tend not to *defend* this state of affairs but rather to fall back on a market fundamentalist logic that ***if*** investors are giving so much money to the industry and ***if*** they are willing to pay enormous fees for the privilege, ***then*** that must mean that the industry is doing something valuable. Everyone understands the risks they are taking and if it all blows up, they will pay the price, as they should.

This logic is fine as far as it goes, which is not very far. The problems are two-fold: First, the biggest investors in PE are not rich people (or,"high-net-worth individuals" in industry parlance), they are public pension funds managed by politically appointed boards on behalf of taxpayers. If the bubble bursts, it is not the managers but the taxpayers who will pay the price. And the evidence suggests that these managers do not understand the risks. Researchers at AQR, a hedge fund that itself manages money for public pensions and has delivered poor returns in recent years, suggest that undue optimism about future PE performance is the result of "the lack of transparency on PE returns and fees, slow learning about performance, and the use of misspecified benchmarks."

Second, workers at the targeted companies have no say in the ever-riskier bets being placed with the companies they rely on for their livelihoods. The PE firms collect fees regardless of how the investments perform. The limited partners spread their money around countless investments and can live with (and indeed expect) a few bankruptcies here and there. Workers have no such luxury—nor do they share in the higher rewards that should purportedly accompany the additional risk. To the contrary, both employment levels and wages tend to fall after an acquisition. The bigger and riskier the bets placed by PE, the worse the outcomes that workers can expect.

These problems highlight weaknesses in the structure of American financial markets that pro-market policymakers can and should address to improve the health and functioning of the nation's financial system. In Confronting Coin-Flip Capitalism, Oren Cass elaborates further on the nature and causes of these weaknesses and outlines an agenda for reform. ■

An electronic version of this article with additional footnotes and sourcing is available at www.americancompass.org.

AMERICAN ATLAS COMPASS

Our Mission

To restore an economic consensus that emphasizes the importance of family, community, and industry to the nation's liberty and prosperity:

REORIENTING POLITICAL FOCUS from growth for its own sake to widely shared economic development that sustains vital social institutions.

SETTING A COURSE for a country in which families can achieve self- sufficiency, contribute productively to their communities, and prepare the next generation for the same.

HELPING POLICYMAKERS NAVIGATE the limitations that markets and government each face in promoting the general welfare and the nation's security.

Our Activities

AFFILIATION. Providing opportunities for people who share its mission to build relationships, collaborate, and communicate their views to the broader political community.

DELIBERATION. Supporting research and discussion that advances understanding of economic and social conditions and tradeoffs through study of history, analysis of data, elaboration of theory, and development of policy proposals.

ENGAGEMENT. Initiating and facilitating public debate to challenge existing orthodoxy, confront the best arguments of its defenders, and force scrutiny of unexamined assumptions and unconsidered consequences.

Our Principles

American Compass strives to embody the principles and practices of a healthy democratic polity, combining intellectual combat with personal civility.

We welcome converts to our vision and value disagreement amongst our members.

We work toward a version of American politics that remains inevitably partisan and contentious but operates from a common commitment to reinforcing the foundations of a healthy society.

American Compass is a 501(c)(3) nonprofit organization.