The Illusions of Private Equity

Contributed by Martin Hutchinson
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The controversy over Mitt Romney’s work at Bain Capital has led me to realize that private equity is a poorly understood business whose economic effects have not yet been fully explored and are in many respects pernicious. This is not a knock on Romney, who in my view would be a mediocre candidate for President however he had made his fortune (although that view might be modified if he had gained it through supreme business creativity like, say, Jeff Bezos of Amazon.) It is also not a knock on Bain Capital, which appears to have adhered to the standard practices of the private equity industry. However that industry itself is of questionable economic utility and many of its practices can fairly be described by Governor Rick Perry’s term of “vulture capitalism.”

I know, because I have been there, and done that – or at least seen it done. As a banker in Croatia I was responsible for a portfolio of over 50 private equity stakes the bank had acquired, mostly through debt-equity swaps in bankruptcy. In some of those cases, adding management value was fairly easy. For example we owned the largest naturist camp on the Mediterranean, whose management claimed that naturism was going out of style because their guests were getting older and older, now with an average age of 58. It turned out that management spent almost nothing on marketing – and I can assure you from observing naked and gloomy 70-year old Germans grilling bratwurst that word of mouth alone did little to attract the more youthful demographic!

The one feature of private equity investing we did not especially use in Croatia was leverage, since the bank already owned the private equity stakes concerned. However leverage, creatively applied, is the key to private equity’s remarkable track record of returns – and to its much less attractive record in creating economic value.

In its initial phase, in the early 1980s, the private equity industry, then known as the leveraged buyout industry, scored some spectacular successes, both in terms of profit and value creation. In January 1982, Wesray Capital, controlled by an investor group led by former U.S. Treasury secretary William Simon, acquired for $80 million (of which the downpayment was rumored to be $1 million) a greeting card company, Gibson Greetings; when this did a $290 million Initial Public Offering just 16 months after the original deal, Wall Street naturally sat up.

At that period, after a decade of inflation and low stock market returns, assets were available at low prices and there were a number of cases in which sizeable companies had been mismanaged by “country club” management, so a turnaround was easy. Leverage was used, but interest rates were so high that only low asset prices and easy turnarounds made the business profitable – it flourished primarily by picking this “low-hanging fruit.”

The growth of the LBO business was spurred by two additional factors: the existence of Michael Milken’s new “junk bonds” trading operation at Drexel Burnham Lambert and the beginning of the long secular decline in interest rates, which allowed buyers to refinance deals at lower than anticipated costs, making them spectacularly profitable.

Inevitably this exceptional profitability drew in additional money. Bain Capital, for example, had begun in 1984 by doing traditional venture capital deals, in which it financed fledgling companies and helped them grow, ideally realizing its investment through a stock market IPO. This initial business unquestionably created jobs, most famously at the office products retailer Staples, founded by my Harvard Business School classmate Tom Stemberg with Bain Capital financing. However venture capital was a chancy business, often taking several years to produce returns and was not especially well suited to Bain, since Bain’s consultants were more used to advising much larger companies. Conversely the well-connected Bain was well able to attract large pools of capital once it had a track record, and was highly plausible when claiming expertise in turning round companies subject to leveraged buyouts. The migration of Bain’s business from venture capital to LBOs was thus unsurprising.

The Drexel crash of 1989-90, the struggles involved in the $31 billion takeover of R.J.R. Nabisco and the tight credit period of 1990-92 caused a recession both in the returns of the LBO business and in its public reputation. The latter problem was solved by rechristening the business “private equity.” Theoretically, this term applied to unleveraged portfolios such as I managed in Croatia, and even to the traditional venture capital business. In practice, the vast majority of the capital involved continued to be devoted to LBOs. In an era of low and declining interest rates, they were by far the most profitable sector of the private equity market, and in those years they required very little ability to carry out. With interest rates low and declining, leverage at unprecedented levels was easy to obtain, at least until 2008 – after all, since the LBO business only got started after interest rates peaked in 1982, its loss experience was excellent.

High and cheap leverage has a number of effects. First and most important, it magnifies the returns available from what were at best marginal improvements in operations. Indeed, the return on saving $100 in operating costs is trebly leveraged. First, if the company is saleable at a multiple of say 7 times EBITDA, an extra $100 saving in the most recent year increases its value by $700. Second, by squeezing hard in the last year before sale, a seller can improve the profits trend, and produce apparent growth in margins where no such growth truly exists – thereby increasing the EBITDA multiple itself. Third, the $700 increase in value of the asset (plus any excess from increasing the EBITDA multiple) flows through entirely to the equity holders, so an asset leveraged 5 or 10 times and squeezed operationally can produce spectacular returns to equity investors. Even after the fees extracted by the management company, outside investors do well, while the management company, typically receiving 20% on any capital uplift for zero investment, gets rich very quickly indeed.

This super-incentive to extract the last penny of savings from the companies they control inevitably leads LBO companies to squeeze their companies too hard. Typically, an LBO managed company will stint on maintenance and research, thereby dressing up operating results and sticking the buyer with an asset that is in poor condition with no product pipeline. The effect of Eddie Lampert’s ownership at Sears exemplifies this. After he bought the company, Lampert determined that a retail operation could be run with far less money devoted to decoration and cleaning than was traditional, which savings could both service debt and increase the value of his investment. Unluckily for him (presumably) the 2008 crash prevented him from selling Sears quickly enough, while customers over time deserted its filthy and poorly staffed stores, so that now, six years after he bought Sears, he is looking at a loss of $421 million in the latest quarter, with domestic same-store sales down 1.2% at a time of 4% inflation.

A second adverse effect of leverage is to incentivize dodgy negotiating and financing tactics. Last week, a former Wall Street banker William Cohan described Bain’s negotiating tactics, whereby they would put in a “final” bid on a company and then chisel down the price during the “due diligence” process when other bidders had disappeared (apparently this tactic was by no means exclusive to Bain). Similarly, the habit of extracting massive dividends, far greater than earnings, from companies they controlled left those companies vulnerable to the merest breeze of recession, endangering excessively the jobs of their employees.

Apart from making business thoroughly unpleasant, such tactics immensely increase the deadweight legal costs of doing deals, as documentation and protections from all kinds of unlikely contingencies proliferate ad infinitum. As we London merchant bankers were very well aware, “gentlemanly capitalism,” in which protagonists can within limits trust each other not to behave badly, is a far more economically efficient way to do business.

A further myth of the LBO business is that it can improve the value of assets it controls through superior management. This may have been true in the early 1980s, after an exceptionally flaccid period of U.S. management, but it has not by and large been true for the last quarter-century. LBO companies typically attract graduates of the top schools, but with an emphasis on those most attracted by “get-rich-quick” schemes who are generally not the most insightful or creative. Add the superior pay and conditions received by LBO staff, especially compared to management of the industrial companies they take over, and you have an extreme “us/them” problem that is barely if at all mitigated by throwing a few top stock options to the favored few among the industrial company’s management.

The problem is exacerbated by cost-cutting, through which favored projects are shut down without notice, while comfortable pension and other benefits are hollowed out and replaced with inadequate money-purchase schemes. The hostility to the LBO’s overstuffed yuppies which this produces is only exceeded by the contempt that rapidly appears for their entire ignorance of many of the basic features of the company’s business and competitive environment. Naturally, with management and workforce hostile to those controlling the business, things go wrong and inefficiencies and corruptions proliferate. The private equity industry nourishes the myth that many LBO managed companies would fail without their involvement; against the companies for which this is true must be balanced the others for which LBO involvement, extracting resources and starving operations, produces failures that would otherwise not have occurred.

Finally, as has become clear in the Bain discussion, the high returns achieved on LBO investments are matched by job losses and deterioration in working conditions – both attractive means for the LBO companies to extract “value.” Even if successful LBO deals on average break-even in job creation, with jobs lost through cost-cutting being matched by those gained through genuine improvements in operations, there are also the unsuccessful deals, in which the LBO company, having invested little, loses relatively little money, but where bankruptcy or facility closure result in massive job losses. For the economy as a whole, the cost of these job losses (and the subsequent periods of unemployment suffered by the employees concerned) must be subtracted from the profits made by the LBO sponsors and their investors to get a true societal accounting.

Through leverage, LBOs often provide investors with higher returns than true venture capital, especially in periods like the present when real interest rates are negative. They also provide quicker returns, and require less effort, because the value creation required is less. However their contribution to overall economic welfare is at best modest, unlike that of true venture capital. We must therefore hasten the return of sharply positive interest rates, which will devastate the LBO business and redirect its resources towards true venture capital, where they are far more valuable to the overall economy.

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Martin Hutchinson is the author of "Great Conservatives" (Academica Press, 2005)—details can be found on the Web site www.greatconservatives.com–and co-author with Professor Kevin Dowd of “Alchemists of Loss” (Wiley – 2010). Both now available on Amazon.com, “Great Conservatives” only in a Kindle edition, “Alchemists of Loss” in both Kindle and print editions.