

Private Equity funds: the rebirth of capitalism?

by

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Everything seems to be going wrong for Private Equity funds at the moment. Apart from being called “locusts” by a German minister or “rapacious” by the economic press, it looks like the financial markets are finally punishing them for their hubris by refusing to grant them the major loans which they require to pursue their activity.

But are Private Equity funds really all that bad? Are they really out to make a quick profit by damaging the companies at the heart of our economies? Are they destroyers of value who take advantage of low interest rates and of the fact that the interest in question is tax-deductible? And is their activity really threatened by a rise in interest rates?

Concerning the accusation of hubris, or over-confidence: it is absolutely vital in this field that the cash flow generated by acquisitions be sufficient to enable a fund to pay off the (high) interest due and to reimburse the debt (which also tends to be high). Therefore cyclical industries, with erratic cash-flow, are not appropriate.

Until this summer, owing to the strong competition between funds for transactions, some players (including the lending banks) appeared to have thrown basic caution out of the window; they will doubtless be bearing the consequences in years to come.

The current cooling down, which was caused by a number of shocks affecting the financial markets owing to the subprime lending crisis and its consequences (which are still not wholly predictable), will doubtless contribute to “cleaning up” the market. Some funds and some banks, due to lack of experience and a desire to clinch deals at any cost, have transcended the boundaries of common sense. This is understandable in an activity which, after several years of growth and high returns on investment, still appears to be characterised by low barriers to entry: new entrants tend to take excessive risks.

However, this does not mean that the sector as a whole is endangered.

Creating financial leverage and waiting is no longer enough

A Private Equity fund is not a machine for buying and selling any company after squeezing it like a lemon.

Firstly because selling a squeezed lemon is in no way a winning strategy. Secondly because the resale price is what is most important to a fund: the lending bank wants to see its interest paid and its loan paid back; the fund and the management (whose interests are most often aligned) achieve their gains based on the growth in the value of the shareholder equity (hence the term ‘*Equity*’ in ‘Private Equity’).

It is clear that the leverage effect contributes to this growth (owing to the fact that the value of the company is equal to the debt plus the shareholder equity, and that as the debt is paid back gradually, the value of the shareholder equity grows mechanically, unless the lemon is squeezed, that is).

Nowadays however, in a competitive market where funds have more money than they can find deals to spend it on, the price of a company tends to include the anticipated returns linked to the leverage effect.

In order to achieve the substantial returns which they promise and which are expected, Private Equity funds must look beyond a company's plans and seek out operational improvements and growth vectors in the companies which they purchase. This is neither easy nor trifling, for the improvements in question must not damage the company's growth prospects, otherwise they might reduce its value and hence its resale price. Nor can the improvements consume too much cash, or they will threaten the financial balance of the deal by increasing the debt.

Therefore apart from putting the company under pressure to perform to the best of its potential, a Private Equity fund must work to achieve growth, and make major alterations to the company's scope which will create value: consolidation with other players in those industries where this might generate benefits in terms of costs or margins, increases in geographical coverage in order to boost growth, restructuring of a company's portfolio of activities or of clients, major reworking of a company's industrial structure, etc.

In this respect, the Private Equity funds are both the instigators and the engines of change. They fulfil a genuine function as creators of value. They are portfolio companies which purchase companies in order to turn them round or boost their growth while maintaining strong profitability.

The new holding companies

Today's Private Equity funds look very similar to the holding companies of the 1960s, such as ITT, whose heterogeneous portfolios of activities brought on, among other things, the famous BCG matrix. In less than 10 years, ITT bought over 350 companies and boosted its turnover by a factor of more than 20, in sectors as diverse as telecommunications equipment, hotels, insurance and food production, etc., before being carved up in the 1970s.

Holding companies at the time appeared to be suffering from bulimia: growth was their key aim, and when from time to time they managed to improve the performance of their acquisitions, through the implementation of reporting systems and bespoke incentive schemes, they would not sell it on. The resulting creation of value ended up being diluted in the miasma of huge heterogeneous companies and the pressure to perform was often lost.

In the 1970s and 1980s, only Hanson Trust used to operate as do today's funds, regularly selling companies or parts thereof. Its shareholders certainly appreciated the results: between 1980 and 1993, Hanson Trust's average yearly TSR (Total Shareholder Return) was nearly 30%!

This is the model being followed by Private Equity funds: they are creating value, and once their incentive and management systems have transformed a company, once their drive to make it grow begins to erode, they sell it on, optimising the return on their investment. They are the holding companies of the 21st century and they are contributing to the (albeit weak) growth of the European economies where they operate.

Far from being locusts, they are caring incubators.

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Estin & Co is an international strategy consultancy based in Paris, London, Geneva and Shanghai. It provides consultancy services to the management of leading European and North American groups in their growth strategies, as well as to private equity funds in analysing, valuing and making the most of their investments.