White Paper

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# Mining the Gems in Private Equity

## Executive Summary

Shortly after the Sarbanes-Oxley Act of 2002 was implemented, it suddenly became very unfashionable to be public—particularly for smaller companies. Out went the emerging growth underwriters of the 1990s (Montgomery, Robertson Stephens, Hambrecht & Quist, to name a few), and in came the leveraged buyout artists to take companies to the promised land of being private…before going public again. So now that enough time has passed, how has it all worked out? That depends. If you were a private company or a limited partner in a private equity fund, the track record has been mixed, at best. If, however, you were a private equity sponsor, chances are that in the era of cheap money that recently ended (and by charging fees for every activity imaginable) you probably did pretty well.

Because of the enormous amounts of leverage associated with private equity investments, along with the lack of a benchmark index for comparison purposes, it can be extremely difficult to accurately evaluate investment performance. The goal of this white paper is to provide financial advisers and their investor clients with a framework to effectively assess potential private equity fund investment opportunities that can play a valuable, return-enhancing role in a well-constructed portfolio. We believe that a value-added private equity fund should possess the following three key characteristics: (i) an identifiable source of "alpha" [see related white paper on this subject]; (ii) the ability to add value to portfolio companies in ways other than through pure financial engineering; and (iii) the use of little or no leverage. There are gems to be found in the world of private equity—the trick is knowing what to look for and where to mine.

KEATING INVESTMENTS

## The Appeal of Private Equity

Private equity is a broad asset class consisting of equity securities in operating companies that are not publicly traded on a stock exchange. Private equity funds may take part in a diverse range of activities, including acquiring private companies in an effort to provide capital, acquiring a division of a large company, or even privatizing a public company in order to make changes.[1] Let's begin by examining the bull case for private equity, as set forth by the Private Equity Council, the industry's trade organization.

***Superior Management Capabilities.*** One of the most compelling arguments in favor of private equity is that under private ownership, managers can focus on long-term goals for the company without the constant short-term, quarterly scrutiny of shareholders. Under this assumption, private equity firms make fundamental business improvements, such as changing business strategy, investing new capital, or injecting new managerial talent (recent surveys show that the senior management team is restructured in 70% of all transactions[2]), that often are more difficult to achieve by current managers working under the constraints of public ownership. Under public ownership, changes of this sort could cause earnings to fall temporarily and anger shareholders. Under private ownership, in theory, these concerns do not exist.[3]

Furthermore, since private equity management teams are often smaller than public management teams, private equity sponsors argue that they can make decisions more quickly and efficiently without having to go through the layers of bureaucracy that can be present in public companies.

***Alignment of Interests.*** Proponents of private equity also argue that their model better aligns the interests of owners and managers than public ownership. In a publicly-traded company, the interests of owners and managers are at odds: Owners want to increase the value of the company, whereas managers are primarily concerned with their own compensation, which may or may not be related to company value.[4] If management in a public company has stock options, there may be some incentive to boost the stock price in the short-term, making moves that could harm the company in the long-term, such as cutting research and development, to increase the value of their assets before cashing out.[5] Since managers in private equity often have much larger ownership stakes than their public company peers, their long-term interests are aligned with those of the shareholders.[6]

***Operational Improvements.*** The enhanced ability to improve operations and the managerial benefits discussed above serve to increase the value of the company, which then generates returns for the investors in the private equity fund. According to the Private Equity Council, from 1991 to 2003, these operational improvements translated into $430 billion of total net profits distributed to investors.[7] Additionally, the Private Equity Council points out, based on 496 acquisitions between 1980 and 2002, companies that went public again after being acquired by private equity firms and operated by them for more than one

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[1] Private Equity Council (2007). *Public Value: A Primer on Private Equity*, p. 7.
[2] *Ibid*., p. 15.
[3] *Ibid.*, p. 5.
[4] *Ibid.,* p. 6.
[5] Lublin, Joann S. "Valeant CEO's Pay Package Draws Praise as a Model." *The Wall Street Journal* Aug. 24, 2009.
[6] Private Equity Council (2007). *Public Value: A Primer on Private Equity*, p. 5.
[7] *Ibid*., p. 2.

year consistently outperformed both the market and other IPOs.[8] The implication is that private equity sponsors are able to garner consistent, above-market returns for investors.

Based on information propagated by the Private Equity Council, one could only conclude that private equity sponsors are blessed with a type of magical, Midas touch. An objective analysis of the numbers, however, paints a very different, more sobering picture. In truth, the vast majority of private equity funds fail to outperform the market when adjusted for leverage risk. Consider the following: From 1980 to 2001, even without adjusting for leverage risk, private equity fund returns (net of fees) were slightly less than those of the S&P 500.[9] You read that right—the funds underperformed the S&P 500. Much more to come on this later. But first, let's review the three key characteristics of value added private equity sponsors.

## Three Characteristics of Value Added Private Equity Sponsors

***An Identifiable Source of Alpha.*** "Alpha" is a measure of risk-adjusted excess return. If a manager generates a return of 15% and the benchmark index returns 10%, the alpha—or outperformance—is 5%. In the private equity world, this alpha can come from a variety of sources. First, there can be improvements to operations, which results in an increase in earnings. Second, there can be a recapitalization of a company, which generally involves piling on huge amounts of debt where little or none existed previously. And third, there can be a "multiple expansion", meaning that the company gets rewarded with a higher P/E multiple when it goes public. This occurs because investors pay a significant premium for the liquidity associated with public companies.

In the world of large buyouts, the private equity industry claims that most of their alpha comes from operational improvements rather than financial engineering. This is easy to understand in the context of distressed companies, but flies in the face of common sense for well-established, profitable companies. How is it that private equity firms can know more about a particular industry than the businessmen who have been in that industry their entire lives?

Consider two case studies: the acquisitions of (i) Texas utility TXU Corp. (more on this transaction to come later in the section on fees), and (ii) the casino operator Harrah's Entertainment—both acquired by Apollo Management. At the time of acquisition, both were thriving businesses that were in no need of the operational improvements promised by private equity. In reality, Apollo simply intended to lever the companies' balance sheets with the goal of generating exits at higher prices.[10] To be sure, we have no particular objection to financial engineering per se. What we object to is false advertising: financial engineering that is disguised as "operational improvements."

***Adding Value.*** At its heart, the venture capital industry is an exercise in creating value through business building at an early stage. In the world of lower- or middle-market private equity, additional enterprise value can be created through efficiently scaling an established, later stage business. Distressed companies, particularly larger ones, create an opportunity for significant amounts of value creation in

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[8] *Ibid.*, p. 7.

[9] Kaplan, Steven N. and Antoinette Schoar (2005). "Private Equity Performance: Returns, Persistence, and Capital Flows," *Journal of Finance*, vol. 60 (4), p. 1791.

[10] Eisinger, Jesse. "The Private Equity Meltdown Myth: Why buyout kinds like Leon Black aren't going out of business." *Condé Nast Portfolio*, March, 2009.

terms of absolute dollars. In larger companies, as a general rule, private equity operational improvements can only come from an outside firm that has either a deeper expertise or an ability to execute a strategic plan more efficiently than incumbent management. In theory, the independent directors of a well-run public company should be ensuring that the management team in place is the best available.

A final area where a private equity sponsor can add real value is in the realm of micro-cap companies, which we define as companies with market capitalizations of under $250 million. Research shows that publicly traded companies are potentially valued higher than comparable private company peers because investors are generally willing to pay a premium for a public stock that they have the option to sell immediately. This means that two companies operating in the same industry with similar revenue, profit margins and growth prospects could have dramatically different valuations based largely on their ownership status, namely whether they are privately or publicly held. This valuation gap can be captured over time by making a pre-IPO investment in a private company and then taking the company public with the goal of having a higher valuation multiple. This is the place to mine for the gems in private equity. A sponsor that is able to take portfolio companies public and cause the P/E multiple to expand meaningfully creates real value for all owners.

***Leverage.*** Returns on a private equity investment can be juiced by putting up a sliver of equity and adding lots of debt to fund an acquisition. This strategy works brilliantly when credit is abundant and cheap, and loan covenants are light—providing that the operating company has enough earnings to cover the massive debt load and still grow. But when the tide turns and asset values begin to decline (think sub-prime mortgages), the existence of an unsustainable debt load simply wipes out the value of the equity. The fate and disposition of the residual carcass is then left for the lenders to decide. To be sure, debt is a sharp, double-edged sword.

Consider 2009: There have already been 53 private equity-owned companies that have filed for bankruptcy, compared to the 49 such companies in 2008.[11] The poster child for this fall from grace has to be Cerberus Capital Management's ill-fated bets in Chrysler and GMAC, resulting in two gigantic wipeouts. Even more ominously, Thomson Reuters' PEHub.com estimates that we are likely to see many more billion dollar bankruptcies from private equity-owned companies because of the enormous amount of buyout debt that comes due in 2011.[12]

## Fees: Private Equity's Dirty Little Secret

In addition to greater risk resulting from leverage and financial engineering, private equity firms have a cornucopia of fees that eat into returns before investors ever see a dime, including: management fees, deal completion fees, consulting fees, performance fees, special events fees, and any other fees that fund managers can come up with to charge investors. Taken together, fees constitute the main source of income for private equity firms.[13] In fact, based on a study of 144 buyout funds between 1992 and 2006, the present value of the fixed fees, those which are pocketed by fund managers regardless of the fund's performance, consume on average 20 out of every 100 dollars under management. Moreover, according

[11] Corkery, Michael. "Reader's Digest Bankruptcy: Private Equity's Graveyard is Getting Crowded." *The Wall Street Journal's Deal Journal*, Aug. 18, 2009.
[12] *Ibid.*
[13] Eisinger.

to one prominent academic study, an astonishing 62% of revenues of private equity firms come from fixed fees![14] According to a study published by University of Chicago professor Steven Kaplan in 2005, even before accounting for risk, over a period of about three decades, the average private equity firm's absolute return was no better than that of the S&P 500 after fees.[15]

As Exhibit A in the fee orgy department, consider the 2007 takeover of Texas utility TXU (now called Energy Future Holdings). In the words of *Fortune* magazine:

> TXU was to be a crowning glory for Texas Pacific Group, Goldman Sachs and Kohlberg Kravis Roberts. At $48 billion it was (in inflation-adjusted terms) as big as KKR's famed buyout of RJR Nabisco. Two years later the deal is shaping up to be a disaster. Except for the insiders. TXU…has barely enough operating profit to cover $3 billion in annual interest payments and no chance of paying off $22 billion in debt maturing by the end of 2014… KKR, TPG and Goldman will presumably take hits to their equity stakes. But they are not doing too badly. The firms split $300 million in fees for the brainwork behind the takeover. Goldman enjoys commissions for handling EFH's commodity hedging and for making a market in its debt. The firms get a percentage of any financing deals and share an annual management fee of $35 million, which increases by 2% per year. For the limited partners in the buyout pools, though, this purchase is all pain, no gain.[16]

## Performance Comparison: Private Equity vs. the S&P 500

Under the auspices of David Swensen, Chief Investment Officer of Yale University, the Yale Investments Office conducted a comprehensive study of 542 completed buyout deals from 1987 to 1998. At first blush, buyouts appear to outperform marketable securities by a landslide: 48% per annum (gross return) for buyouts vs. 17% for the S&P 500. Yale then made two adjustments. First, the buyout returns were adjusted for management and performance fees, resulting in a net return of 36%--which still appears to be comfortably above the S&P 500. And second—and this is critical—Yale then adjusted the S&P return to have equivalent amounts of leverage to that used in the buyout control group. Here are the results in David Swensen's own words: "Comparably timed, comparably sized and comparably leveraged investments in the S&P 500 produced an astonishing 86% annual return. The risk-adjusted marketable security result exceeded the buyout result of 36% per year by an astounding 50 percentage points per year."[17] Swensen's conclusion about private equity is unambiguous: "In fact, only top-quartile or top-decile funds produced returns sufficient to compensate for private equity's greater illiquidity and higher risk."[18]

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[14] Metrick, Andrew and Ayako Yasuda (Jun. 9, 2009). "The Economics of Private Equity Funds" *The Review of Financial Studies* (forthcoming).
[15] Eisinger.
[16] Helman, Christopher. "TXU Buyout Looking More Like a Bust." *Forbes*, Sept. 7, 2009.
[17] Swensen, David F. *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment*. New York: Free Press, 2009, p. 225.
[18] *Ibid.*, p. 224.

## Conclusion

Properly selected investments in private equity do generate superior returns relative to other equity alternatives, though often with higher levels of risk and illiquidity. As with any mutual fund or other actively managed financial product, the challenge for advisers is how to identify these top-quartile funds. The three key characteristics that a top-quartile fund should possess are: (i) an identifiable source of "alpha"; (ii) the ability to add value to portfolio companies in ways other than purely through financial engineering; and (iii) the use of little or no leverage. To the extent that an investor can participate in a publicly traded private equity vehicle, the illiquidity risk can be either mitigated or eliminated. There are gems to be found in the world of private equity—the trick is knowing what to look for and where to mine.

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Keating Investments, LLC is a Denver-based SEC registered investment adviser founded in 1997. The firm is the investment adviser to Keating Capital, Inc. (www.KeatingCapital.com), a publicly reporting Business Development Company that is an equity capital partner for select private businesses that are primed to become public companies. The fund does not use any leverage. Timothy J. Keating is the founder and President of Keating Investments. Previously, he held senior management positions in the equity and equity derivative departments of Bear Stearns, Nomura and Kidder, Peabody in both London and New York. He is a 1985 *cum laude* graduate of Harvard College with an A.B. in economics. He can be reached at (720) 889-0131 or at tk@keatinginvestments.com. Vivek Ratnam, a student at Princeton University and summer associate at Keating Investments, contributed research for this white paper.