Viewpoint: The Impact of Private Equity on the U.S. Economy

Thad Gray, Chief Investment Officer

September 2012

The current election cycle has brought heightened attention to the private equity industry as a business model and the role that private equity plays in the United States economy. To paraphrase the founders of one large private equity firm, "none of us asked for the scrutiny of a Presidential campaign—however we are in this together." As long-term participants in the private equity market, we at Abbott Capital thought it might be an opportune moment to share our thoughts and perspectives on this important topic.

Critics of the private equity business model sound a refrain that is familiar to us: in a nutshell, private equity investors are "locusts", "flippers" and "asset strippers" who use other people's money to limit their risk, shut down factories and lay off employees to cut costs and pocket huge personal gains if everything goes right.

Proponents of private equity see this business model in a totally different light. Private equity provides start-up capital to emerging industries, growth capital to expanding segments of the economy and is an agent for the restructuring of America's ageing industries. Moreover, private equity provides hands-on ownership and a long-term focus that allows companies to operate in an environment where there is less public scrutiny of short-term, quarter-to-quarter results. Private equity seeks long-term gains from operational improvements that result from active governance and by investing in growth, not in cost cutting. Greater operational efficiencies and higher corporate growth rates resulting from private equity stewardship can lead to higher investment levels and higher employment. Private equity is not just a benefit provided to a small handful of wealthy people. The potential for higher returns that private equity provides can offer enhanced retirement security for millions of ordinary American workers (from firemen and policemen, to office workers and cafeteria workers) by enhancing the returns of pension funds that have, at times, made up more than 50% of the private equity investor base. Private equity can also provide vital investment returns for not-for-profit endowments and foundations who are also major investors, allowing them to fund scholarships and charitable benefits for thousands (if not millions) of people in need.

As private equity market participants, we are instinctually inclined to subscribe much more heavily to this more sanguine view of the industry. However, a decent respect for the fragmented opinions of a polarized body politic requires a candid examination of the available academic research and facts at our disposal.

Perhaps the most contentious question is whether private equity creates or destroys jobs. One of the most comprehensive research papers on this topic is "Private Equity and Employment" by Steven Davis (The University of Chicago), John Haltiwanger (University of Maryland), Josh Lerner (Harvard Business School) and two other authors from the U.S. Bureau of the Census (August 24, 2011). This paper uses U.S. Census Bureau databases to track employment at private equity-backed companies in the United States and compares employment levels at "target" (private equity-backed) and "control" (comparable, not private equity-backed) companies in periods before and after buyout transactions. The analysis captures new establishments opened after a deal is completed as well as post-buyout acquisitions and divestitures. The overall conclusions are not straightforward, showing that "target firms exhibit substantially greater job destruction in establishment shutdowns, more job creation at establishment births, more employment losses through divestitures, and greater employment gains through acquisitions." The paper continues, "In other words, target firms undergo more job reallocation activity post buyout than control firms. These results support the view that private equity is a catalyst for creative destruction as measured by job creation and destruction and the purchase and sale of business units." Ultimately, the study finds a difference of only 0.26 percentage points in employment in the two years post buyout in favor of target firms, thus essentially zero net impact on employment growth. However, the study finds that private equity acts as an agent of restructuring (or "creative destruction") within target firms, as there is a much higher pace of job creation and destruction due to establishment births and deaths of businesses at target firms than at control firms. Thus, jobs don't really get created or destroyed as a result of private equity transactions, however the evidence shows that they get reallocated at a higher rate.

Further obscuring this analysis, data show that employment responses vary by type of private equity transaction. Public-to-private deals are more likely to involve target firms with a strong need for cost cutting, and demonstrate significantly higher employment contraction than controls. However in "private-to-private" transactions, employment at targets grows 10% relative to controls in the first two years post buyout. While public-to-private transactions make up a minority of deal volume, they garner much more public scrutiny. Data also show that employment responses are markedly different between transactions in manufacturing, retail and service companies. Thus, objective analysis would caution against painting with an overly broad brush when characterizing employment outcomes in the wake of private equity transactions.

Putting aside this issue of job creation (or destruction), the qualitative benefits of private equity are more clear cut. Private equity provides a completely different governance model compared to public ownership. With almost all sizeable public companies, there is a fragmented ownership structure where even the largest shareholders have little direct mechanism to influence management. In most cases, management has the freedom to heed the advice of public shareholders as it sees fit. Frequently, public company boards are deliberately filled with management cronies who may act as a rubber stamp for the executive team. The private equity ownership model is completely different. Private equity investors typically obtain control stakes or minority positions with significant influence. Under this model, executive management reports to a board of directors composed in large part of representatives from the controlling private equity firms. Frequently, the private equity investors set the strategic direction for the company, and management is held directly accountable for its success or failure. This generally leaves little room for inept management to hide and, certainly, no cronies to turn to. Even more significantly, the private equity ownership model typically requires a long-term time frame for the strategic vision set by the control investors to be executed. Frequently, companies targeted by private equity are underperforming, or at the very least not reaching their full potential. In such cases, the only hope for a positive investment outcome is to transform the portfolio company. However, transformation is rarely successful overnight and is frequently non-linear. The public market's quarter-to-quarter scrutiny of earnings results and its impact on share prices can be a major impediment for the kind of long-term focus that is required to fundamentally transform businesses and make them better. Public companies typically have highly fragmented ownership structures where the largest institutions act as passive investors with few governance mechanisms and where stakeholders are highly focused on the near-term share price. For example, among the 30 companies comprising the Dow Jones index (as of 6/30/12), the median ownership interest held by the *largest* institutional shareholder was 4.7% and the average was 5.6%. In only two of the component companies (American Express and Home Depot) did any single shareholder represent greater than 10% of the equity. The typical ownership structure includes between 1,000-2,000 institutional shareholders. This often leaves no effective voice to challenge, corroborate, motivate and hold management accountable for its decisions. It is the opinion of this author that the principal factor explaining the historically superior long-term returns of private equity compared to the public markets is the private equity ownership model, where highly qualified financial and operational professionals actively drive the performance of their portfolio companies and provide accountability for management through control of the board of directors. It is probably instructive that one of the few institutional shareholders in the public market that has adopted a similar control model, Berkshire Hathaway, has also outperformed the public markets on a consistent basis.

It is more difficult, however, to quantify the source of private equity returns. Most private equity firms systematically analyze the components of value creation attributed to EBITDA growth, debt paydown and multiple expansion. Most firms we have encountered appear to derive the large majority of their value creation from EBITDA growth. However, within the component of EBITDA growth, how much comes from top line growth and how much comes from margin expansion? As for margin expansion, how much comes from cost cutting and how much from other operational improvements or simply more competitive products? Like the issue of job creation, it is unlikely that the precise answer is knowable. However, from a public policy perspective one could confidently believe that regardless of how earnings growth is derived, if private equity is acting as a catalyst to make American companies more competitive, that this is a good thing for the health of the American economy in the long run. The Japanese economy, which in the absence of meaningful private equity transactions has a corporate structure dominated by hidebound conglomerates, is perhaps a cautionary tale offering an example of the stagnation that can result in the absence of the "creative destruction" that is frequently catalyzed by private equity.

While private equity has typically been associated in the public media with buyouts and growth capital, the impact of venture capital on our economic landscape should not be forgotten. Venture capital provides startup and growth capital to young companies largely in emerging industries that would otherwise only obtain financing from under-resourced "angel investors". In the last decade, venture capital investment in the United States has averaged between $20-$30 billion annually. Historically, venture capital has played an instrumental role in creating high growth industries such as information technology, biotechnology, semiconductors, online retailing and more recently clean technology, cloud computing and social media. A significant number of world-leading, iconic American technology companies once started with early stage venture capital financing. Well known examples include Apple, Microsoft, Amazon, Google, Cisco, Intel, Oracle, Amgen, Home Depot and eBay, however these household names only tell a small part of the venture capital success story. The success of highly visible venture capital startups inevitably spawned imitators which in turn led to additional startups and the development of a high tech "ecosystem" that has attracted many of the world's best and brightest scientists and entrepreneurs to American shores. According to the NVCA, as of 2008 venture-backed companies in the United States accounted for 12.1 million jobs, or 11% of private sector employment. Job growth at venture backed companies between 2006-2008 was estimated by the NVCA to be approximately eight times higher than total private sector job growth (1.6% annually versus 0.2% annually). Given the venture capital industry's focus on information technology, life science and clean tech, a large proportion of these jobs must be assumed to be highly skilled "green collar" jobs that are crucial for America's economic competitiveness.

A frequent misconception about private equity is that the returns only benefit the extremely wealthy. This may have been the case in the 1940s through the 1960s, when private equity was the domain of a handful of families such as the Whitneys and the Rockefellers, however it is far from the truth today. In the last thirty years, the private equity investor base has been heavily dominated by pension plans, endowments and foundations and more recently joined by sovereign wealth funds. In the case of pension funds, the ultimate beneficiaries of private equity investment returns include firemen and policemen, teachers and cafeteria workers, factory workers and office workers. Pension plans that are clients or investors of Abbott Capital Management alone contain over 1.8 million plan beneficiaries, thus the broad impact of private equity in creating retirement security for ordinary Americans should not be underestimated. Endowments and foundations that invest in private equity have used the historical gains created by private equity to fund scholarships and charitable benefits for people in need. Data show that private equity investments have outperformed the public markets by substantial margins across all measurement periods. As of December 31, 2011, the pooled return of Thompson Reuters partnerships has outperformed the S&P 500 by 510 basis points, 400 basis points, 270 basis points and 290 basis points over 5, 10, 15 and 20 year time periods, respectively. Consider the powerful effect that even a 290 basis point difference in returns produces as a result of compounding. A pension fund with $50 million exposed to private equity over a 20-year time horizon would have garnered $183.8 million (as of December 31, 2011) in incremental asset growth from its exposure to private equity (compounding at 11.6%) than if the same assets were invested in the S&P 500 (compounding at 8.7%). However, specific examples are even more compelling. In the case of the Oregon Public Employees Retirement Fund, the time-weighted annual return on private equity investments since 1981 was reported at 11.35%, versus 4.71% for the S&P 500 over the same period, translating into $4 billion of incremental investment returns for that pension plan as a result of its investments in private equity. On June 25, 2012, Private Equity at Work published an article which concluded that, "without private equity returns there will be fewer teachers in Oregon and reduced resources for endowments to distribute to students in need of an education". In addition, the historically higher returns from private equity have had a direct fiscal impact on states and municipalities whose pension plans invested in higher returning private equity investments by reducing the "liability shortfall" which would otherwise have to have been made up with higher tax contributions. In light of the above, it would not be an overstatement to say that tens of millions of ordinary Americans are either direct or indirect stakeholders in the private equity market.

In conclusion, private equity appears to play a positive role in the United States economy in several respects. Private equity is clearly an agent for a more dynamic and efficient allocation of capital both to emerging industries and toward the restructuring of more established and ageing industries. When the impact of venture capital investment is considered, private equity has helped fund the development of a high technology "ecosystem" that has been a magnet for scientists and entrepreneurs from around the globe. Lastly, the higher investment returns historically offered by private equity compared to public market alternatives have funded the growth of retirement and charitable assets benefitting millions of Americans and has helped alleviate the potential burden on taxpayers created by public pension shortfalls.