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Private versus public equity: which creates more value?

BY JAMES BRANDMAN

The public face of private equity has taken quite a bashing recently. As the industry's growing financial clout continues to afford it more high-profile buyout opportunities, public figures from around the world are taking advantage of PE's traditionally secretive nature to launch largely unfounded attacks. In February, the UK's GMB union criticised the tax relief PE firms enjoy and singled out PE heavyweight Permira in particular, following its decision to cut jobs at frozen food manufacturer Birds Eye and motor service firm Automobile Association. In a recent interview with the BBC, Permira managing partner Damon Buffini cited fashion chain New Look and hotel operator Travelodge as examples of his firm's ability to generate value for the companies that comprise its portfolio. New Look added an additional one million square feet of retail space and Travelodge built 100 new hotels under the firm's ownership. "Both have become very strong businesses and employ thousands more people. That's not asset stripping," he said.

New research reports published recently by AT Kearney and others use hard data to show that PE-backed companies increase revenues more quickly than non PE-backed companies. "In a review of 12 recent empirical studies on PE's large scale impact on value and employment, we found no empirical evidence to support the contention that PE destroys jobs. In fact it is just the opposite," says the AT Kearney report, *Creating New Jobs and Value With Private Equity*. The industry has created over one million new jobs in Europe alone over the past 4 years. And companies backed by PE capital increase sales more quickly than their non PE-backed peers, on average between 4 and 26 percent a year, the report says.

In a European survey, 90 percent of PE-financed companies reported higher growth than their traditionally financed competitors (Centre for Management Buyout Research (CMBOR) & European Venture Capital Association (EVCA), 2002). In the UK, the average annual growth rate was 20 percent as compared to 8 percent for FTSE 100 companies. The 60 companies in TA Associates' portfolio, for example, grew their revenues by an average of 20 percent year-on-year in 2006, according to Ajit Nedungadi, managing director and head of the London office of TA Associates. "This is phenomenal. You'd be hard pressed to find a collection of randomly selected non-PE companies with that kind of a growth profile," he says. PE is also better at helping companies penetrate more deeply into existing markets and expand into new markets, says the AT Kearney study.

But PE's detractors cite the high debt burdens placed on portfolio companies to finance their acquisition as evidence of value destruction. "Elements of the current debate about the PE industry seem neither sensible nor particularly enlightening," counters Arthur Stewart, partner and head of the PE practice at Simmons & Simmons. "We all have enormous amounts of personal debt on our properties, which most people are fairly comfortable with. Buyout professionals are simply using the same opportunity to take on high levels of debt to buy companies."

It is important to understand the differences between the public and private ownership models, according to Mounir Guen, CEO of PE advisers MVision. "PE is not a corporate raider," he says. "It aims to bring strategic change with a sense of urgency to a company." PE brings in consultancy, financing, accounting and banking services to the management of a company in a single package, he says. "This attitude towards debt is just a fundamental misunderstanding," adds Oliver Tant, global head of PE at KPMG. "Provided the business is profitable to some degree, buying it using debt is a relatively cheap way of financing the deal."

In a study on MBOs and MBIs, the EBIT (Earnings Before Interest and Taxes) margin on average rose from 4 percent to 7 percent after the buyout, says the AT Kearney report. In a pan-European survey, 72 percent of participating portfolio companies reported that investments had risen (CMBOR & EVCA, 2002), while a UK study found annual investments increased by an average of 14 percent in PE-backed companies, compared with just 3 percent in the private sector (BVCA & IE-Consulting, 2005). "On average, PE-backed firms outperformed the market both in terms of revenue generation and job creation," says Sandra Niewiem, manager at AT Kearney and co-author of the report. "Operating profits are typically higher than non-PE backed companies in similar segments. PE-sponsored companies also invest more in the business."

Between 2000 and 2005, sales at PE-backed companies rose by 20 percent a year, more than twice that achieved by FTSE 100 and FTSE Mid-250 companies. Exports, meanwhile, grew by 27 percent a year compared with a national growth rate of just 3.9 percent, and investment rose by 14 percent compared with a national increase of just 3 percent.

Intriguingly, research on this subject is unable to clearly identify the reasons why a PE-backed company is able to grow sales and revenue faster than a comparable publicly-listed business. "Rather than being any more sophisticated from a management or strategic point of view, you could argue that the very nature of buying a business with a view to exiting within three to four years puts a lot more pressure on PE and therefore a real focus," says Mark Pacitti, corporate finance partner at Deloitte. "The PE industry employs efficient capital structures and uses them to put pressure on management teams to operate the business more efficiently," adds Paul Goodson, a managing director at Barclays Private Equity. According to Pacitti, PE is in a position as a majority shareholder to determine and execute a company's strategy effectively, whereas the numerous institutional and private shareholder interests public companies have to satisfy make it more difficult to follow a clear and focused strategic path.

"In terms of corporate strategy, the PE-backed business will be able to react more quickly to acquisition opportunities and the auction process than a corporate buyer," he says. In PE, the owner of the business is more actively involved with the management of the business, says Goodson. In contrast, public market shareholders simply back what they perceive to have value. "But if it doesn't work out, they just sell up. They do not act like owners," he says. "There are many situations where quoted ▸▸

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companies have soldiered on with failing management teams year after year because nobody was prepared to take ownership of the problem."

PE-backed companies can speed up the investment process without regard to short-term profitability and therefore achieve longer term gains more rapidly, according to Tant. Quoted company shareholders, on the other hand, expect quarter-on-quarter as well as annual profit growth. This makes it very difficult to launch new operations systematically, as the costs associated would have a severe impact on both quarterly and annual earnings, something the public markets tend to punish quite severely. "It can be difficult to raise money in the public markets, particularly for medium-sized companies in less-favoured industry sectors," adds Mike Wright, professor of financial studies and director of CMBOR. "This is where PE players can identify opportunities for restructuring and growth, as well as bring in extra finance to exploit economies of scale."

As well as due to its secrecy, much of the industry's negative public perception has centred on job losses. But even an analysis of independent CMBOR research by The Work Foundation shows that around 60 percent of PE companies expand jobs over six years, while just 36 percent cut them. PE is therefore an easy target. "From time to time, financial institutions such as investment banks or large corporates streamline their businesses and lay off large numbers of highly paid investment professionals or management," says Stewart at Simmons & Simmons. "But of course, there isn't the same controversy about these job losses in the press, or from unions or government." Citigroup, for example, is planning to cut 17,000 jobs. Its net income fell for the third straight quarter in Q1 this year, declining to $5.01bn from $5.64bn a year earlier. "Nobody questions the right of an independent corporate group's management to rationalise its business in the interests of its shareholders. So the criticism of private equity here is pretty unfair," says Stewart.

Holiday and insurance group Saga, which was bought by Charterhouse in 2003 for £1.35bn, has increased staff by 28 percent, mostly through growing the business organically. When comparing the performance of PE-backed businesses with their publicly-listed competitors, it is PE that holds the beacon for value creation. While UK department store Debenhams was under the ownership of CVC Capital Partners, Texas Pacific Group and Merrill Lynch Private Equity, it improved its ailing market performance by concentrating on top-line sales growth and rolling out women's fashion subsidiary, Desire. Now it plans to open 29 new stores in the next five years. Its direct competitor House of Fraser, meanwhile, in the first six months of 2005 posted losses of £4.4m before it was bought by a consortium led by Icelandic investor Baugur for £351.4m last year.

TA Associates invested $40m in software security company Sophos in May 2002 when it employed around 280 people. It now has close to a thousand employees, with the vast majority of that growth having come organically, according to Nedungadi. "This is a UK company that has expanded its presence substantially at home, in North America and in continental Europe," he says. "Under our ownership, this business has taken its product sales from around £35m to £87m this year." Its direct competitor SurfControl Plc, meanwhile, only managed to grow revenues from £97.8m in 2005 to £101.9m last year.

Another TA Associates portfolio company, Drive Assist, had a turnover of around £33m when it was bought by the firm back in December 2003. For the 12 months to May 2007, turnover at the vehicle replacement provider will have tripled to around £105m, and from nearly 400 employees in December 2003, today it employs over 1200 people, says Nedungadi. In comparison, competitors Accident Exchange increased turnover from £21.7m in 2005 to £53.5m in 2006, and in the final six months of 2006, HelpHire grew its revenue 41 percent to £126m compared with the same period in 2005. While both of these listed companies show impressive rates of growth and value creation, they still fall short of their PE-backed competitor. "When Compass came to sell Travelodge, there weren't too many people other than PE firms prepared to buy the assets in the first place," says Tant at KPMG, who advised Compass on the sale. "The deal was mainly a PE-driven process, as they were prepared to pay the highest price. This is frequently the case in the market at the moment."

PE-backed portfolio companies already employ at least six million people across Europe, amounting to 25 percent of total employment across the 600 major European public companies, according to AT Kearney. "The overall range of annual employment growth was between 2 and 18 percent for PE-backed firms," says Niewiem at AT Kearney. "Even where PE-backed companies were experiencing losses, often in turnaround situations, the management team still had a targeted and well-focused rationale. In the US, we found that PE-backed companies in industries in recession on average cut fewer jobs than their traditionally financed competitors."

According to AT Kearney's report, Global Insight/NVCA (2004) calculated an employment increase of 600,000 in the US between 2000 and 2003; NVCA & IE Consulting (2005) in the UK calculated that PE job creation exceeded 364,000 over the course of 2005, while ASCRI (2005) found that more than 63,300 new jobs were created in Spain during a three-year post-investment period. "We looked at the employment profile of our portfolio businesses from the date we invested in the companies," says Nedungadi at TA Associates. "Six of the companies we've invested in since 2002 have grown their employee base from 1500 to over 4500 employees."

Between 2000 and 2004, the number of people employed by PE-backed companies in the UK increased by an average of 14 percent a year compared with a national private sector employment growth rate of 0.3 percent. According to 85 percent of companies that took part in this study (BVCA & IE-Consulting, 2005), this growth was organic rather than acquisition based. While PE-backed firms were able to strengthen their workforce, segments of non PE-backed businesses actually cut employment levels over this period (minus 0.2 percent for the DJ Stoxx 600, minus 1 percent for the French CAC 40, and minus 0.7 percent for the US private sector).

"Statistics about job creation are all very well, but these are not what the public are looking for," argues Guen at MVision. "They want to know what PE is and who these people are." The problem is that PE firms prefer to make statements rather than enter a dialogue with their inquisitors. But pursuing that dialogue proactively has now become critical for the industry, as regulators, governments and other public bodies begin sharpening their knives. "The industry has to engage more openly with the broader stakeholders in our business and social environment," says KPMG's Tant. "Having no base of information or understanding about what it is that PE does, many commentators have perceived the lack of engagement by industry protagonists as sinister wrongdoing."

By their very nature, firms in this industry don't much enjoy being in the press. But in their own self-interest, PE firms need to do a better job of managing their public relations lest ill-informed criticism or misplaced legislation begin affecting their returns. Quoted companies could learn a great deal from the PE model. They could benefit from having more sophisticated investors; an incentivised, knowledgeable and aligned management group; a focus on creating value through growth; and a renewed sense of urgency, according to the Boston Consulting Group. As Tant at KPMG concludes: "The question shouldn't be why PE operates in the way that it does and whether it should be doing so. It ought to be: Why are public companies not implementing PE-like strategies to create greater value for their shareholders?" ■