Cole Associates Corporate Finance
White Paper
Is Private Equity Good for the Economy?
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Private equity has attracted its fair share of adverse publicity over the years, some merited, some ill-informed and unfair. In this White Paper we attempt to unpick the criticisms of private equity as a form of corporate funding and ownership, and to determine whether it is a force for good in the UK economy.

Firstly, let's clarify what we mean by private equity. It is a form of finance provided by private equity Funds to companies for acquisitions and expansion in return for an ownership stake. The private equity Funds themselves receive their funding from pension funds, insurance companies, high net worth individuals, sovereign wealth funds and other institutional investors who are prepared to take a little more risk with funds allocated to private equity than, say investing in the stock market, and therefore expect a higher return. The Investment Directors of those Funds are tasked with finding opportunities to invest in privately-owned businesses in such transactions as corporate acquisitions, management buy-outs and buy-ins and growth capital. Private equity is normally accompanied by bank debt in funding such transactions, although, since the credit crunch of 2008 the quantum of bank debt available for such transactions is much-reduced.

The objective of a private equity Fund in taking an ownership stake in a business is very simple and one-dimensional - to achieve the highest possible compound return on its investment over a period (typically 3-7 years) via repayments of principal, interest, dividends and exit proceeds (sale of its shares). A typical aspiration will be compound returns of 15-25+% over the entire period of investment. Of 10 investments, a quarter might be expected to fail, half will be expected to provide modest returns and a quarter will be expected to be 'stars'. In most cases the management team of their portfolio companies also have a shareholding, and this 'alignment' of interests is an important aspect of the private equity model.

Venture capital is similar to private equity in principle but is normally associated with the backing of start-ups and early stage businesses.

The criticisms of private equity Funds tend to fall into the following areas:

- Reduced headcount in portfolio companies as part of cost-reduction strategies.
- Asset stripping (buying businesses as a going concern and selling off parts on the basis that "the sum of the parts is worth more than the whole").
- Paying too little tax
- Increased risk of company failures by using large amounts of debt to part-finance acquisitions.
- Increased risks for employees' pension funds by increased leverage.

Taking each of these issues in turn:
Employment:
To create the investment returns alluded to above private equity Funds work with the management teams of their portfolio companies to increase profits as, in simple terms this should lead to a) profit & cash generation to repay debt, and b) increased share proceeds on sale, given that a company's value is generally based on a multiple of its profits. Profits can be increased by (i) increasing revenues, (ii) reducing costs and (iii) improving operational efficiency. Therefore headcount reduction is one way of reducing the overall cost base, but this generally only makes strategic sense as part of wider changes to improve operational

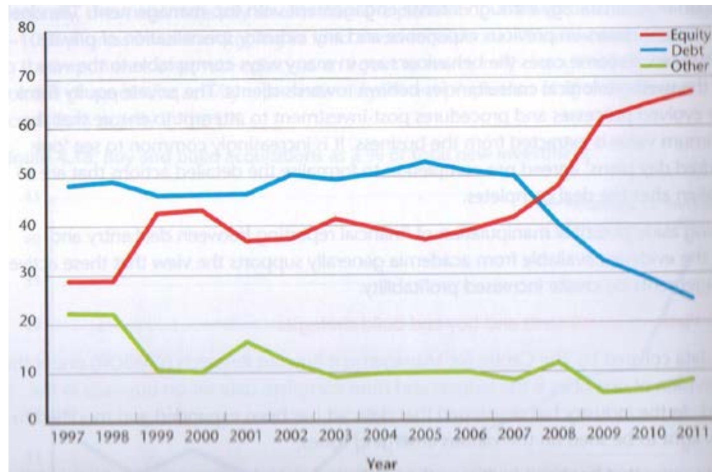
efficiency across the business. Reducing headcount in isolation as a short term mechanism to reduce the cost base and increase profits would rarely succeed in creating medium or long term shareholder value unless the business was previously simply over-manned. The economic logic follows that improving the operational efficiency of a business (which might involve headcount reduction in the short term) should lead to enhanced prospects for successful medium-long term growth of the business, which will, in turn lead to increased employment to levels higher than those of the former 'inefficient' smaller version of the business.

The surveys and research in the UK and US over the last 30 years on the effect of private equity ownership on employment are numerous, and the findings are mixed. One recurring theme is that there is often a trend of headcount reductions immediately after investment (interestingly, often reductions in indirect headcount more so than direct headcount) followed by a partial recovery of headcount during the remaining period of investment, and a further increase after exit, by which time the company may be publicly listed. Clearly successful venture capital investment in high-growth businesses will definitely create employment.

Asset stripping:
Entertainingly depicted by Richard Gere's role in the 1980s movie Pretty Woman, the image of private equity Funds buying businesses and breaking them up or selling core assets for financial gain or to repay debt is a common criticism. Given that the clear objective of the private equity Fund is to create value between investment and exit, it is intuitively not going to be in their interests to sell key assets. It is not uncommon for private equity shareholders to rationalise a diverse business by selling non-core parts of it, but this is not 'asset-stripping' in its pejorative sense, it is improving the overall operational efficiency of the business and making it 'fit for purpose'.

Tax:
This criticism tends to fall into three areas:
1. Situations where the interest burden of the debt (some of which is provided by the private equity Funds as well as banks) extinguishes all or most of the portfolio company's Operating Profit, resulting in little or no Corporation Tax liability. This is legitimate 'financial engineering' and, whilst the portfolio company will pay less Corporation Tax, it will still be paying the PAYE and NI of its employees and the VAT on its sales (less input VAT). The banks receiving the interest will also pay tax on that income.
2. Some private equity Funds use complicated offshore ownership structures to minimise their tax liabilities on interest received, dividends and capital gains on share sales. Again, this is legal and is the prerogative of any business to arrange its tax affairs so as to pay the minimum tax within the law.
3. The Investment Directors who make the investment decisions and monitor the investments often have a "carry" (small personal stakes in the companies in which the Fund invests), the sales of which on exit are taxed as capital gains, so at a lower rate of tax than income tax. The carry can often account for a large proportion of their overall earnings. In 2007 Sir Ronald Cohen, a founding father of private equity in the UK admitted that tax breaks mean he pays a lower tax rate than his cleaner. Again, the private equity Funds are making the most of the tax regime, as any taxpayer is entitled to do. The gains they are creating are, in a wider sense good for the economy and must be creating taxable profits and income elsewhere.

Increased risk of corporate failure due to high leverage (bank debt):
Since the credit crunch the wind has rather been taken out of the sails of this area of criticism. There is much less bank debt available for private equity-backed buy-outs (see chart below) and many Funds have had to provide more of the funds themselves; they would not do this if to do so would heighten the risk of failure.



Increased risk to employees' pension funds:
Again, the reduced availability of bank debt post-credit crunch has muted this concern. Nevertheless, when Alliance Boots was acquired by KKR the pension fund's chairman expressed disappointment that the transaction did not include an injection of funds to eliminate or reduce the £305 million pension fund deficit. However, there are laws to protect employees' pension funds, there is the government pension bail-out fund and pension liabilities receive preferential treatment in insolvency situations.

So, in summary while it helps to make eye-catching headlines and sell newspapers, in our view most of the popular rhetoric aimed by the media against the private equity industry is ill-informed and misplaced. The private equity Funds' imperative to create economic value in their portfolio businesses creates a form of protection and mutual interest for other 'stakeholders' such as employees in the long term. Also, such economic behaviour at the 'micro' level of individual companies is likely to have positive economic impacts on the wider economy (although private equity Funds are not acting consciously in this altruistic way), as economist Adam Smith suggested in 1776 in "The Wealth of Nations":

> *"the butcher, the brewer or the baker intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it".*

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