The surge in private equity

Forces at work and potential casualties

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Private equity: the spur of capitalism?

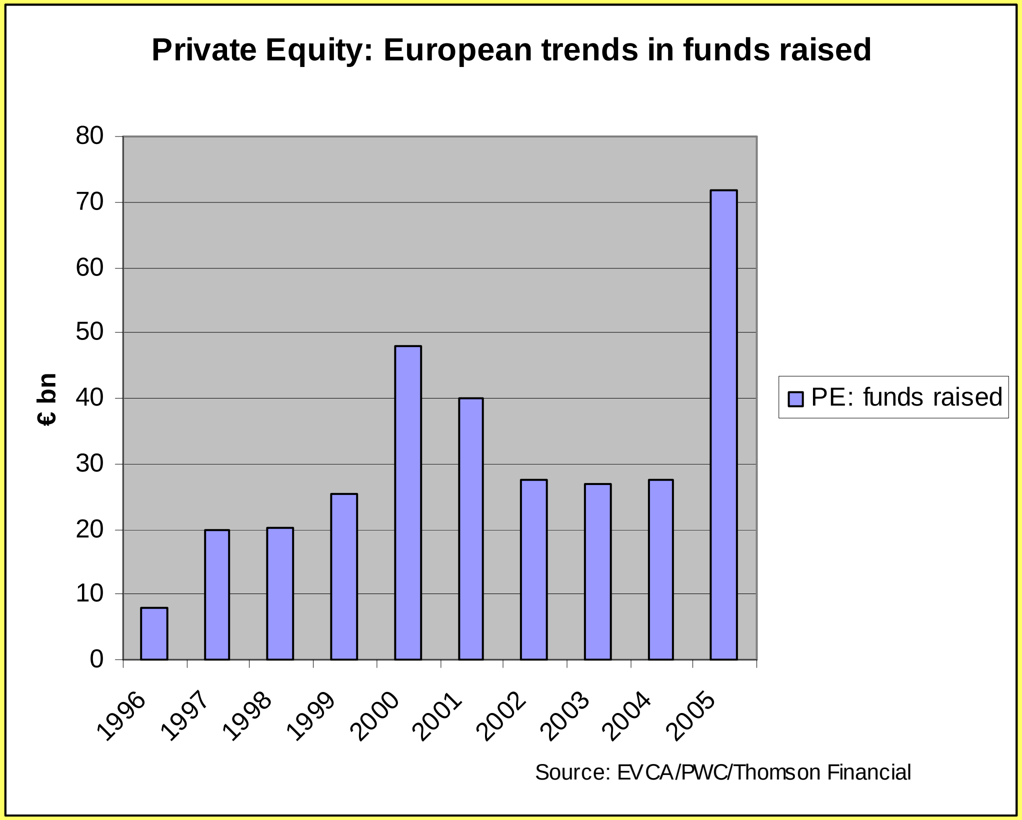
- **Development of private equity funds**
- **Investment strategies**
- **Risk assessment**
- **Economic and social impact**

Private equity: a fast-changing industry

Shift in focus

	Buy-Outs/total (%)
1996	58
2000	50
2001	55
2003	73
2004	74

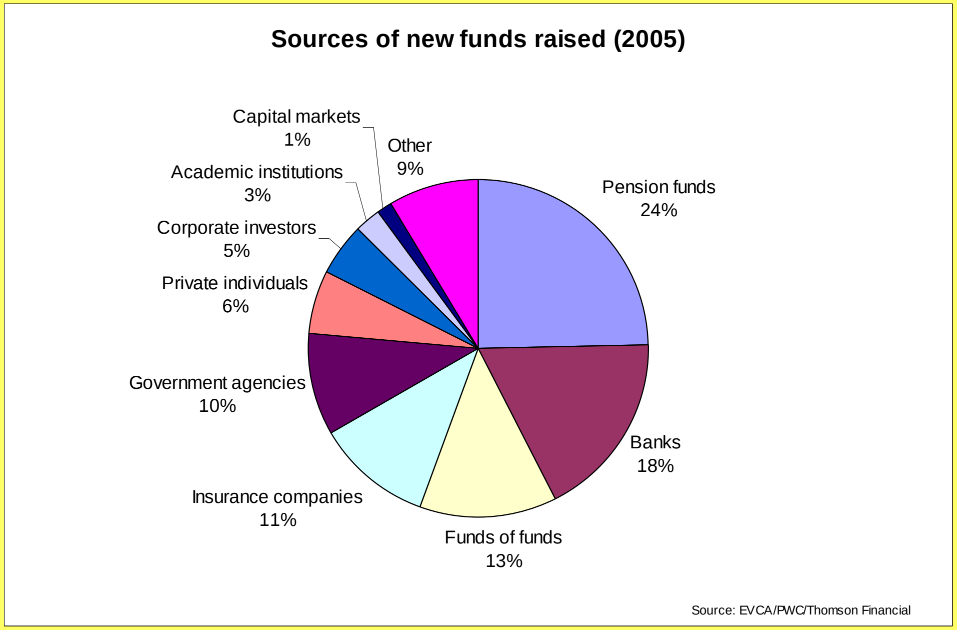
- Investment in innovation that was the landmark of the new economy era has receded. PE funds are mainly involved in buying existing companies.



Private equity: a new asset class

Alike hedge funds, PE funds have benefited from capital brought by:

- Pension funds: 24% of funds raised in 2005
- Investment banks and large commercial banks: 18%
- The third contributors are Funds of Funds (e.g.hedge funds themselves) for 13%
- The share of wealthy individuals, dominant in the 1990's has shrunk to 6%.



The forces that nurture private equity

- PE is part of "*alternative asset classes*" that have come into fashion after the Stock market crash in 2001-02:
  - Low long-run interest rates and heavy losses on equities spurred the demand for yield (α) and for diversification (low β) by institutional investors with long horizons (public pension funds and endowment funds).
  - Those institutions have transformed their own governance: in-house strategic asset allocation, specialized delegation under core/satellite model, active management.
- The fancy for PE has made it a significant share of investment: 8% of asset under management in US public pension funds under assumptions that are highly questionable:
  - Higher net yield than tradable assets
  - Low correlation with tradable assets

Investment strategies in private equity

- PE investments pertain to *absolute return* assets:
  - No performance projection, no guaranteed return, no market valuation of acquired assets $\longrightarrow$ Monitoring fund management virtually impossible for outside partners.
  - Long-holding period (3 to 5 years) and huge discrepancies in performance from one fund to another: *The ability to select managers a priori is crucial*.

- PE is divided into sub-categories, all involving **real risks:**
  - ***Venture capital*** closely related with entrepreneurial strategy.
  - ***Expansion capital*** is associated with later stages in the development of start-ups.
  - **Buy-out capital**: redesigning product lines, restructuring operations, transferring ownership in existing companies and delisting public companies to shield them from the scrutiny of transparent markets.

Is private equity a profitable bet for institutional investors?

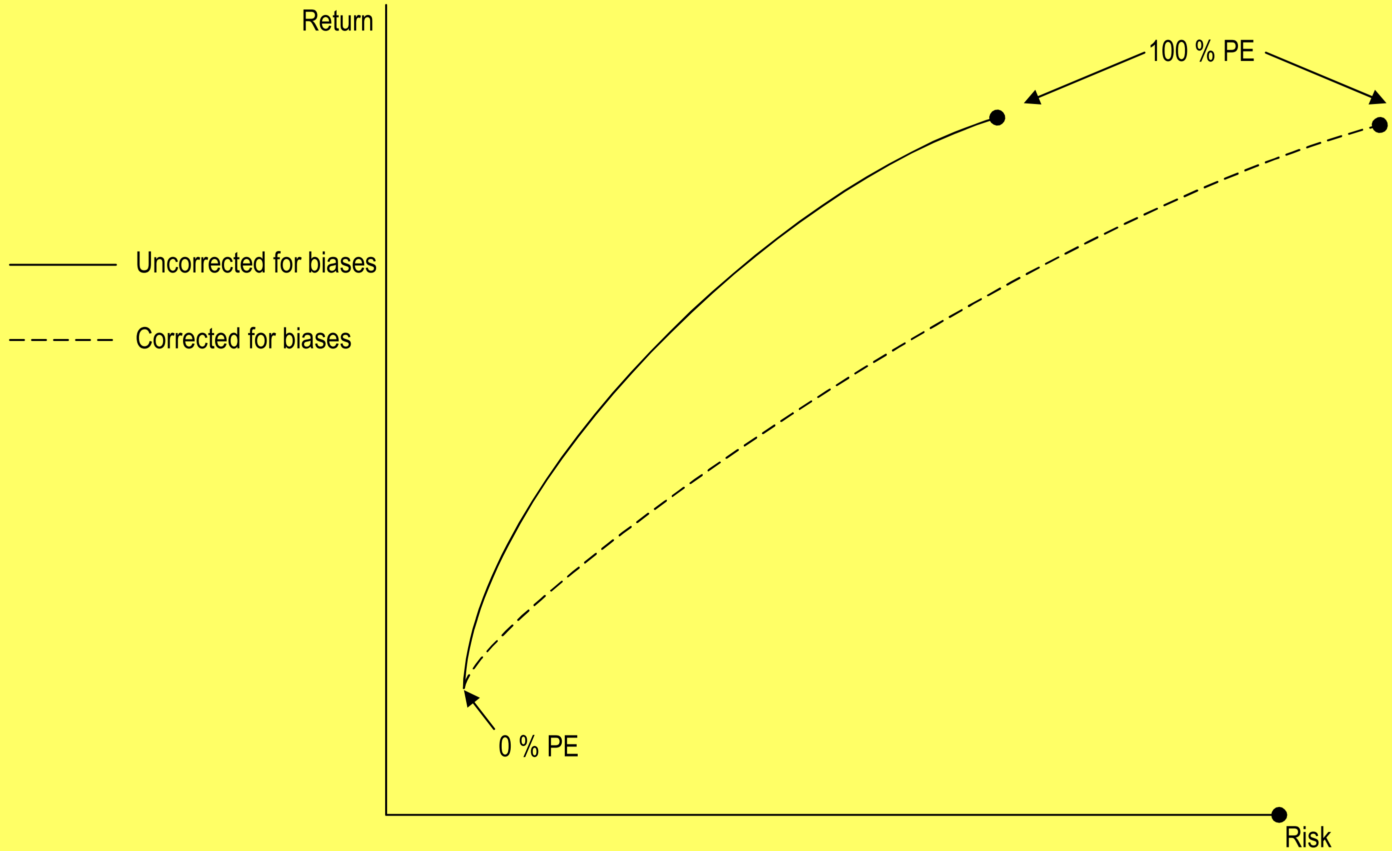
- **The structure of risk is very far from being Gaussian**:
  - *Skewness* and *kurtosis* risks are very high.
  - Buy-outs are akin to event-driven hedge fund strategies: skewness~-2.6 and kurtosis~20.
  - It ensues that *the standard measure of risk* (Sharpe ratio) *has no meaning* and the standard method of portfolio allocation (linear relationship between risk-adjusted returns of individual assets and market return) is irrelevant.
- **Private equity is a highly illiquid asset class:**
  - The risk of illiquidity for an institutional investor is the risk of not being able to rebalance that part of the portfolio because the assets are stuck for several years.
  - The risk should be compensated by *a liquidity premium*. Portfolio simulations show that it reaches about 3.5 to 4% on average.

Is private equity a profitable bet for institutional investors?

- **Correlation with equity markets is high and variable:**
  - *Multiple bias in the measure of performance* : worst performers are not registered in indices (survivorship bias, selection bias). Infrequent valuation $\longrightarrow$ spurious auto-correlation of yields.
  - *Correction of bias exhibits high and variable correlation with equities*: in Europe 50% on average on 1994 Q1-2004 Q2 and apparently over 90% in the February 2007 turmoil (Merryl Lynch).
- **Buy Outs are highly leveraged:** it explains much of the higher performance and the hidden higher risks of PE.
  - A recent City Group study shows that, if one applies the same leverage to a basket of US mid-cap quoted stocks and back-tests the performance over a 10-year period, *the public market sample fares better*.
  - The combination of high leverage and low liquidity is deleterious for investors in PE under adverse market conditions. *The net return might be mediocre all the more than fees are prohibitive.*

PE: seemingly higher return and hidden risk

- Skewed and leptokurtic distribution of risks, illiquidity and variable correlation with other asset classes and high leverage make **standard portfolio allocation inadequate and potentially dangerous.**
- Portfolio: bonds/marketable shares/private equity $\longrightarrow$ applying standard portfolio theory without correcting for biases gives a false sense of safety.



Impact on corporate governance

- With PE, firms are treated like financial products: 3 to 5 years horizon may have a negative impact on innovative investment in target companies.
- PE funds extract cash flow in indulging in *asset stripping* and distributing extra-dividends *(recaps)*, thus weakening productive investment or loading companies with excessive debt.

	'Real' Economy	**Financial Markets**
(1) Time horizon	Long term	Short term
(2) Modus operandi	entrepreneurship (Schumpeter)	speculation/ arbitrage
(3) Incentive	Viability of the firm as a going concern	Allocation rebalancing with market opportunities
(4) Risk	Internal pooling of risk (governance principles)	External shedding of risk (portfolio diversification)
(5) Responsibility	Implicit/tacit contracts (hierarchy and trust)	Formal contract (opportunism)
(6) Asset specificity	High (no exit-option) (sunk costs)	low (exit-option) (liquidity)

Impact on social responsibility

- **Change in employment:** +jobs in finance, +precarious and low-skilled jobs, - stable and skilled jobs in industry.
- **Pressures on labor costs:** offsetting the heavy financial load and achieving the much higher financial return required by shareholder value.
- **Deterioration of social climate:** PE general partners take the control of the board of acquired companies to maximize the capital gains in reselling the firm a few years later → *They have no interest in collective bargaining.*
- **Cuts in specific investment in human capital:** those investments are profitable for the firm as a going concern and are realized in a time span much longer than the horizon of PE.

Impact on public services

- **Operating public services: a target for PE**
  - ➢ Natural monopolies=high and stable profit margins
  - ➢ Capital intensive firms= lavish cash flow
  - ➢ Right to use public goods without due compensation
- **Conflicts between long-run investments required to provide the services of public infrastructures and PE objectives**
  - ➢ Heavy debt loads restrain investment needs in R&D and quality improvement of public services
  - ➢ Threat on universal access of public services at affordable prices for everybody
- **Regulatory authorities must strengthen the control on the governance of public service operators that have surrendered to PE funds.**