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Musings

#72: The Private Equity Debate
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A newer target of the progressive political class is private equity. If you listen to Elizabeth Warren, private equity is bad segment of our capitalistic system which destroys companies and jobs. She has introduced legislation called the Stop Wall Street Looting Act (per earlier musings, note the framing the conversation with naming), it would impose a 100% tax on fees paid from companies to the PE firms that buy them and prohibit dividends for two years after an acquisition. So what is the deal?

Private equity professionals raise money from limited partners to invest. These limited partners are pools of capital like endowments, insurance companies and pension funds. The managers of the pools of capital are charged with generating returns so they allocate the money across asset classes with some going to “alternative” asset classes like private equity. David Swensen (who manages Yale’s endowment) pioneered the allocation of much larger amounts to alternatives and has generated enormous returns for the university. Now, everybody does it. Lots of money has been going into private equity over the last thirty years.

The PE professionals get the money for a set period of time (typically ten years although fund lives are getting longer). The basic concept is they buy private companies, grow their profitability and then sell them within that time period. The PE team usually gets “2 and 20” meaning a 2% annual management fee on the fund (to pay for offices, salaries etc) and 20% of gain in value/profits on the sale (called carried interest). So what is the issue?

PE firms are usually more aggressive in their use of debt (“leverage”) when buying a company. So just like having a bigger mortgage on a house, they typically put up less money themselves and maximize the money from the banks. This increases the equity returns for investors. However, it also makes the business more precarious if times get bad. Many of the retailers and companies which have been gone bankrupt are due to heavy debt loads from private equity buyouts.

There is nothing wrong with using some leverage. It is a matter of risk. When a company gets over-levered and goes under, the PE firm loses all of its money so it is not something they want. In business school corporate finance, you are taught to lever “to the point of financial distress.” The judgement call is how much in debt payments a company can afford and having cushion for tough times. For example, with all of the uncertainty in the world right now, leverage should be limited in my opinion. In my opinion, you should never have 5+ leverage multiples (debt/ebitda) on a business. Max it out at 4sh and pay down to 1-2x as soon as you can.

PE professionals are usually very smart and bring a lot of value to running a business. Increasingly they are vertically-focused and really know what is going on in a given market. They bring significant fiscal discipline. Often, companies are run in cash-inefficient ways and PE ownership can change business processes and create a more efficient company (why did Sears own all of that real estate?) PE-owned companies also know how to effectively do acquisitions and can create large organizations in a way that non-institutional ownership could not.

In one of the great ironies, a large beneficiary of the above market returns from private equity are teacher and other public worker pension funds. So while many members of these professionals protest with Elizabeth Warren against capitalism and private equity, their retirement pension is being made possible by the work of their targeted evil.

The issue is that raised in the guest "trust in institutions musing" by Adam Weinberg. It is not about the organization but the individuals. PE can't be about maximizing the income of the PE professional. It has to be about building great companies. If a PE firm gets too aggressive with leverage and dividends, it can leave a business in a precarious state and ultimately things might not work out and jobs lost. The best PE people I know are not aggressive with leverage.

It is also hard to argue why the compensation of the PE professional in carried interest is treated as capital gains for taxes rather than ordinary income. This is "profit-sharing" and they did not write a check to invest and take risk. It should be taxed at the higher ordinary income tax rate.

Like most things, there is nothing inherently wrong with private equity. It is how it is practiced.

Back to work.

jml

Second Thoughts

Good essay on the racial unrest from Kareem Abdul-Jabaar. dont-understand-the-protests-what-youre-seeing-is-people-pushed-to-the-edge

For those waiting to know, the court gave Carol Baskin the zoo. carole-baskin-tiger-king-zoo-trnd