Private Equity is Done…Well, Not Quite (Last of a Series)

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This week we wrap up our three-part response to the contention, as argued in an articulate WSJ op-ed by Andy Kessler that the glory days of private equity are over.

One interesting contention made by Mr. Kessler is that PE is "holding back the economy." He uses examples of buying drugstores and car-rental companies, leveraging them to the hilt, and then being unable to invest in new products and services.

Having operated around private equity sponsors for decades, we've observed them to have missions other than just driving the economy. Their goal is to create value for their shareholders and limited partners. To do this, PE firms seek to buy companies for which they can make specific operational and strategic changes that enhance that value.

For example, if a company makes a terrific consumer product, but has limited distribution, the sponsor can leverage its management experience and help the company get on the shelves of major retailers to take revenues to the next level.

But if the company has bloated inventories, unprofitable SKUs, and money-losing stores, the sponsor will take the necessary steps to reduce losses, improve margins, and do whatever is needed to turn the business around. That may involve closing stores and plants, and reducing headcount in the short-run. But without intervention, those things would have happened eventually, perhaps in bankruptcy. With PE involvement, there's a better chance the company will survive to reinvent itself to a better future.

Speaking of employment, the notion that private equity destroys jobs in the economy has enjoyed almost mythical status, particularly during the last presidential campaign. Certainly the media has done its share of spreading this fable around. Our experience, and some solid statistics, points a very different conclusion.

Two years ago the Association for Corporate Growth (of which your correspondent is a board member) commissioned a study from three independent databases that analyzed 23,211 private equity backed companies compared to an overall set of 52 million US businesses. The study showed that from 1995-2010 the cumulative job growth of PE-owned businesses was 64.4%, while all businesses was only 18.3% [link].

Finally, Mr. Kessler argues PE is out of "fat targets" and needs to start "new companies rather than squeezing the last life out of old ones." We agree. The best PE firms, particularly in the middle market, understand the days of achieving top-tier returns with leverage alone are over. Generalists are at a disadvantage to those with differentiated industry knowledge. Sponsors with networks of experienced executives trolling for opportunities have an edge over those whose deal flow relies solely on auctions.

Private equity is not done, far from it. It is a mature industry going through a period of portfolio harvesting, perhaps followed by retrenchment and consolidation. Some firms will thrive in the new normal, and some won't.

The days of effortless 30% returns may indeed be gone. But it's a zero growth world out there. With $535 billion of undeployed capital, and thousands of companies trying to create value for themselves and their employees, it seems as if private equity has plenty of work still to be done.