

Why Private Equity Matters (Part Two)

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Private equity as an asset class delivers strong returns to investors, often better than public market benchmarks (see [Chart of the Week](#)). It also diversifies investor portfolios with access to smaller high-growth private companies. As PE becomes available to high-net-worth investors, understanding how these investments work is essential for a sophisticated wealth program.

While the first buyers of middle market companies were not strictly PE firms, so-called leveraged buyouts (LBOs) quickly became their focus. Think of PE sponsors as investment businesses that buy private companies (or take public companies private) using a combination of debt and equity, boost their value, and sell them for a profit—typically within 3 to 7 years.

The first thing to understand about buyouts is why they happen at all. Families or entrepreneurs can be challenged to grow their companies without outside capital, especially those too small to go public or issue bonds. Banks provide working capital, but not equity. It's also difficult for founders to realize value in cash without selling their businesses to a competitor. A PE firm can buy some or a majority of that ownership, allowing the seller upside.

Another key feature is financing. For LBOs, PE firms use debt the way homeowners use mortgages – to stretch their equity cash farther to buy the property while enhancing returns. Unlike 20% cash-down residential mortgages, sponsors' share is typically 40-60%. Private credit managers finance the purchase with loans secured by assets and cash flows of the company.

The PE firm works with the management team to grow the company's earnings while also using cash flow to pay down the borrowed money. When the company is eventually sold, the debt is repaid first, with the remaining profit split between the private equity firm and its investors. This often includes key members of the management team and founder families.

That's the third critical point. PE raises capital from limited partners (LPs) – insurance companies, pension funds, family offices – who commit to general partner (GP) funds. GPs operate on behalf of the LPs, sharing gains and losses based on how well portfolio companies and funds do. Those investors have full access to all performance data for those businesses. How transparent the GPs are is a major factor as to whether LPs invest in the next fund.

What makes PE attractive is how firms create value during their ownership. They don't buy, then sit back and watch. They increase revenues and enhance margins by streamlining operations, cutting unnecessary costs, implementing better systems and reporting, upgrading management talent, and pursuing strategic growth opportunities. Many firms invest meaningfully in enterprise resource planning systems, customer relationship management platforms, and other technologies that professionalize the business.

And that's the final point. Despite how they are sometimes portrayed, PE firms don't buy businesses to strip assets and fire employees. The goal is to take a good business and make it better, so that when it's finally sold, everyone – investors, owners, and employees – benefits.

