Private Equity

Capitalism's Misunderstood Entrepreneurs and Catalysts for Value Creation

DAVID HAARMEYER

> [T]he problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them.
>
> —Joseph Schumpeter, *Capitalism, Socialism, and Democracy*

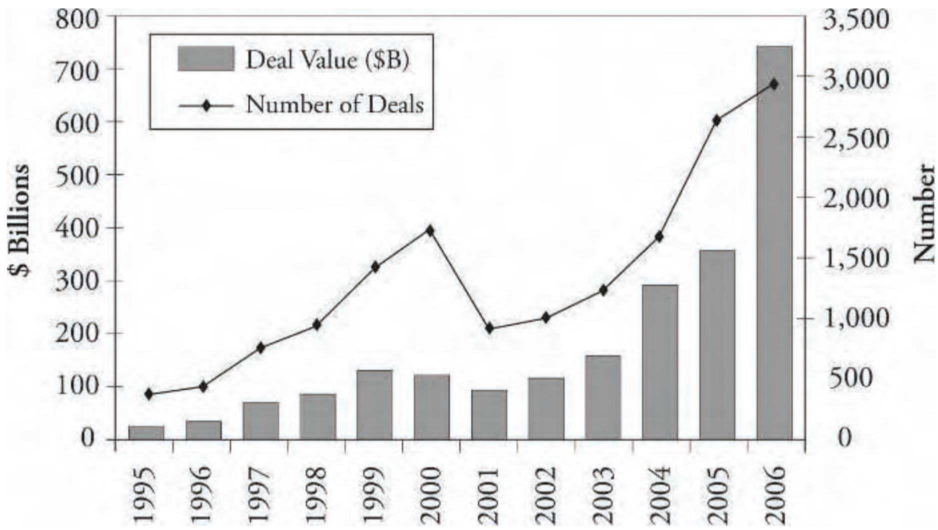
Private-equity partnerships, especially in the form of leveraged buyouts (LBOs), have grown in size and number at an unprecedented rate during the past few years. In 1990, the business attracted less than $10 billion from investors. In 2006, however, more than 680 private-equity funds raised $432 billion, and the value of deals reached more than $700 billion (see figure 1).[1] Driving this growth has been the impressive record of a number of large buyout groups in consistently generating superior returns for investors by overhauling the ownership structures of private and

David Haarmeyer is a director at PowerAdvocate, an energy supply chain company. He also writes independently, as in this article, on markets and active investors.

1. Communications with Mark O'Hare, managing director, Private Equity Intelligence, January 2007. According to PEI, the industry raised a record $240 billion in the first half of 2007.

The Independent Review, v. 13, n. 2, Fall 2008, ISSN 1086–1653, Copyright © 2008, pp. 245–288.

Figure 1
Global Buyouts: Value and Number of Deals



Source: Dealogic 2007.

public companies. According to Thomson Financial, over the past three years, the S&P 500 averaged 9.9 percent returns, whereas buyout firms averaged 15.6 percent returns (McCafferty 2007). Higher expected returns and greater diversification are enticing institutional investors such as pension funds and endowments to allocate increasing amounts of capital to this alternative class of investments and away from public equities.

Yet, according to the views expressed in the financial press, by politicians, and even by a few financially astute investors, private equity provides little if any net value to the economy. Indeed, in liberal pundit Michael Kinsley's opinion, it is "a capitalist swindle" (2006)—a few are getting rich at the expense of the many.[2] This complaint is familiar; it is, indeed, what many regard as the problem with capitalism, the economic system that relies on private property and markets to allocate resources (Muller 2002).[3] Private equity is a vital element of the capitalist system. The private-equity revolution of recent years represents an evolutionary change in capitalism that works by aligning the interests of two sets of critical parties: corporate managers and inves-

2. Kinsley's all-encompassing thesis is that financial markets don't work: Why else would public companies be priced at one value, yet private-equity groups buy them for another and then sell them for another price? According to Kinsley, "[I]f these deals aren't a swindle, then the stock market itself is a swindle" (2006). The static, uncompetitive view that the stock market "leaves money on the table" gets nods by more than a few money managers who also think buyout groups are "stealing" public companies.

3. See Muller for a fascinating look at the long and colorful history of the hostility toward trade and money making. He makes clear that from Socrates ("the more men value money making, the less they value virtue") to and past Karl Marx, the anticapitalist undercurrent has been strong (2002, 4).

tors, and investment managers and investors. This feat of organizational innovation helps to check the resource waste and corporate malfeasance that often hold back, if not sink, public companies.

That many people are skeptical of capitalism or even completely against it goes a long way toward explaining the bias against private equity. Behind both views is a familiar mix of ignorance, populist resentment, and self-interest, which creates fertile ground for government intervention. In this article, I seek to provide a better understanding of what private-equity firms do and to correct popular misunderstandings about them.

What Private-Equity Firms Do

As an extension of capitalism, private equity works to create value by moving capital, labor, and technology to more valued uses—in particular, from organizations with weak ownership incentives to ones with strong incentives. It does so by transforming the ownership and organizational structure of public and private companies. LBOs swap equity for debt, concentrating ownership in fewer hands, which results in much stronger incentives to manage a firm's resources productively. Unlike shareholders in a public company, the key owners in an LBO—a private-equity group and the managers—bear fully the consequences of their decisions. With concentrated ownership comes much greater accountability, better stewardship of a company's resources, and sharper incentives to create value.[4] Buyout partners are today's financial and operational entrepreneurs as they put their own capital at risk and drive an innovative organizational process that creates tremendous value.

This ownership-centered model is the hallmark of active investors because it involves taking significant stakes in public companies to monitor management and often to influence corporate strategy. Active investing dates back to the turn of the twentieth century, when J. P. Morgan's "men" sat on the boards of the companies in which Morgan's bank invested. Today, active investors include hedge-fund activists, such as JANA Partners, ESL Investment, Carl Icahn, and Atticus Capital; lower-profile financial investors, such as Warren Buffett and Wilbur Ross; and LBO partnerships. The investment strategy of Buffett's Berkshire Hathaway is often to acquire a significant stake and a board seat in a company. According to Berkshire's *Owner's Manual,* "most of our directors have a major portion of their net worth invested in the company" (1999, 1).[5] Eating their own cooking makes private-equity and other active serial investors highly motivated to create value while maintaining the integrity of the investment process.

4. Economist Larry Summers once observed, "No one in the history of the world has ever washed a rented car." Why not? "Because they didn't own it and preserving its value wasn't important" (in Wessel 2002). So it is with many public companies—a vastly different ownership form than private equity.

5. The manual goes on to note that partner Charlie Munger's family has 90 percent or more of its net worth in shares and that Buffett and his wife have more than 99 percent (Berkshire Hathaway Inc. 1999).

One of the significant benefits of the public-company structure is that it offers an ownership base of well-diversified public stockholders, which tends to provide low-cost equity capital and a capacity to bear the risks of a cyclical economy. A highly diversified shareholder base implies, however, that few if any of these owners will have information on a company's prospects, such as that gained from sitting on a company's board, that is as good as the information that management has, nor will they have much *incentive* to gain this information or to monitor the management because their stake is so small. With private equity, in contrast, the informational asymmetry between investors and management disappears.[6] Alignment of interests fosters stronger incentives to perform and removes a big source of corporate governance problems.

Private-equity limited partnerships (LPs), which raise funds and make investments on behalf of limited partners, take various forms, including buyouts, venture capital, mezzanine capital, and distressed capital. Buyout funds, which focus on taking public companies private, and venture capital, which provides entrepreneurs with startup capital, are the two largest and best-known forms. In general, all of these forms of equity capital tend to have common attributes, including:

- *Investors:* Wealthy individuals, endowments, public and private pension funds, and insurance companies are the primary investors, or *limited partners,* in private-equity funds. These sophisticated investors have the wherewithal to meet the high minimum commitments that private-equity funds require.
- *Fund life:* A finite, contractually fixed life of five to ten years is set up, after which investors expect to recover their capital plus a substantial return. Each partnership fund is legally separate and managed independently of a private-equity group's other funds.
- *Management fees:* Private-equity *general partners,* who make, monitor, and actively manage their investments, generally charge an annual management fee of 1.5 to 2.5 percent of committed capital to cover operating expenses.
- *Profit sharing:* General partners' key incentive for creating value is a 20 percent carried interest, or profit, taken generally after the limited partners' capital has been returned.[7]
- *Capital at risk:* General partners usually invest a significant portion of their net worth along with the limited partners' money. These sums tend to reach 1 to 2 percent of a fund's total capital. Limited partners look for this coinvestment as a sign of a private-equity firm's commitment.
- *Light regulation:* A greatly underappreciated factor in private equity's success is

6. Another key distinction between private and public equity pertains to liquidity. Capital raised privately for an LBO fund is much less liquid than capital raised for a publicly traded company. This difference highlights the different degree of due diligence that investors in the two equity forms undertake.

7. Some private-equity groups, such as the Blackstone Group, operate with "clawback" provisions, which enable investors in down years to take back profits gained by a buyout group in up years.

> that it has taken root in large part because government interference is minimal relative to the regulation of investment in public companies. For example, in the United States, private-equity ownership is exempt from registration with the Securities and Exchange Commission (SEC) because going-private transactions do not involve a public offering.[8]

Creating a much more levered capital structure is a critical part of what drives the organizational transformation of LBOs and explains their growth across the economy and increasingly throughout the world. A buyout group, generally with a public company's management group, will take a company private by replacing ("buying out") public equity with debt and concentrating equity in the hands of the buyout group and the firm's management. Where before the buyout a public company may have had a capital structure of 60 percent equity and 40 percent debt, after the buyout debt is pushed up to about 70 percent and equity down to 30 percent, with the management owning perhaps 10 percent of the equity and the buyout group holding the rest. The change in the capital and ownership structure has fundamental implications for the organization's governance and performance.

Powerful incentives to make value-enhancing changes over a five- to ten-year period are created when owners and managers have their own capital at risk, must return capital to limited partners, and are legally obligated to pay off debt. Unlike a public company, a private equity group will have multiple levers to create and harvest value, such as initial public offerings (IPOs), mergers, recapitalizations, distributions, and roll-ups. Moreover, through their normal operations of structuring and overseeing their portfolio companies, private-equity groups guard against a number of potential corporate governance problems.[9] Concentrating ownership mitigates the biggest source of governance problems that occur when managements' interests are not aligned with shareholders'.

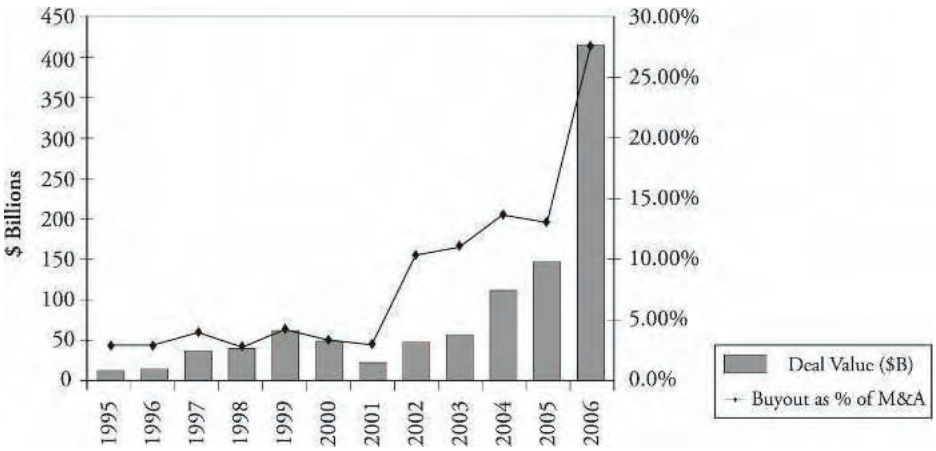
Private equity's flexible ownership model has proved widely applicable in nearly every industry and in a growing number of countries. More than one in five mergers worldwide is a private-equity transaction, and the number rises to more than one in four in the United States and the United Kingdom (see figure 2).[10] With their own capital at risk and a need to return funds to limited partners, private-equity partners are smart buyers—they tend not to overpay. Acquisition bids from privately held companies tend to push prices up 22 percent, whereas public-company bids drive up

8. Dallas Federal Reserve Bank economist Stephen Prowse points to Japan and Germany as two latecomers to private equity because of "the heavily regulated nature of their securities markets," which made them rely much more on bank financing (1998, 32).

9. Despite the dramatic growth of private-equity groups, few have been tainted by fraud or scandal either directly or through their involvement in the many companies in which they hold ownership interests (Haarmeyer 2006).

10. "Private-equity deals represented some 20% of the overall M&A market last year, the biggest in history at $3.7 trillion, according to Thomson Financial" (Berman 2007a).

Figure 2
U.S. Buyout Deals: Value and Percentage of Mergers and Acquisitions Market



Source: Dealogic 2007.

the price of a target company by 32 percent (Stulz et al. 2007).[11] It also helps that buyout groups can deal with some of the more serious restructuring and governance problems to which large public corporations are especially susceptible and which may become justifications for costly government intervention. For example, Chrysler Corporation, on the verge of bankruptcy in the late 1970s, requested and received a $3.6 billion bailout from U.S. government. In May 2007, private-equity group Cerberus announced a $7.4 billion deal to acquire 80 percent of Chrysler from its German parent company DaimlerChrysler AG. In 1989, Daimler-Benz paid $36 billion for the chronically underperforming company. Buyout groups have been active in purchasing business units of a number of large, unwieldy, and sometimes poorly governed public companies, including General Electric, Ford, Boeing, and General Motors. In doing so, they restructure the firm to tighten its strategic focus and increase the value of the remaining core business (Guerrera and Politi 2007c).[12]

LBO groups' overwhelming success in taking companies private, restructuring them, and building better-performing businesses has given private-equity groups control of large parts of the global economy. Kohlberg Kravis Roberts (KKR), one of the

11. Another important insight from this research, which is fully consistent with the advantage of ownership, is that the extra premium that public companies pay for acquisition targets disappears if managers of the acquiring firms own at least 20 percent of their companies. Ownership matters.

12. Jeffrey Immelt, chief executive at GE, noted the difference that the proliferation of buyout groups has made when he said, "Today, there is infinite capital. That wasn't true five years ago, wasn't true 10 years ago, may not be true five years from now. But you can literally today sell any business you have at the drop of the hat" (Guerrera and Politi 2007c, 1).

pioneering LBO groups, has a portfolio of thirty-five companies, with $95 billion in annual revenue and about 540,000 employees (Sender 2007). In the United Kingdom, approximately 3 million people, or 19 percent of private-sector employees, are working for companies controlled by buyout firms (Werdigier 2007).[13] Moreover, whereas the growth in employees at publicly traded companies in Great Britain has generally averaged 1 percent per year during the past five year, the number of employees at companies backed by private-equity firms has grown 8 percent a year.

Especially for the larger buyout organizations, the emphasis often extends beyond going-private transactions to include other alternative investments, such as hedge funds, real estate, and venture capital. These organizations therefore may be categorized better as global-asset managers. A 2006 Citigroup report observed that "private equity managers have grown from small transaction groups to large and diverse asset managers, some of whom are now among the most sophisticated organizations in the world of finance" (Klein, Zenner, and Shivdasani 2006). Blackstone Group's listing of a 20 percent stake for as much as $7.8 billion in June 2007 marks yet another evolutionary step as these financial entrepreneurs seek to secure more permanent capital.

Moreover, buyout groups have moved beyond financial engineering to include operational experts such as former IBM CEO Louis Gerstner, hired by Carlyle; former GE CEO Jack Welch, hired by Clayton, Dubilier & Rice; and former BP (British Petroleum) CEO Lord Browne, hired by Apax Partners.[14] Not long ago, few executives in public companies would have considered working for a private company or taking their company private in a buyout. Today the costs of being a public-company executive have increased, and the benefits have diminished. Post-Enron, public-company management has the additional responsibilities and liabilities imposed by the Sarbanes-Oxley Act of 2002, more unfriendly "independent" boards, and threats of compensation regulation.[15] Under the glare of the public markets, public-company executives are more susceptible to litigation risks and pressures to meet quarterly

13. This source also notes that sales of private-equity-backed firms rose 9 percent a year in each of the five years, compared with 7 percent for FTSE 100 members, and that "a company is on average 70% more productive after being acquired by a private equity firm than before" (Werdigier 2007). These figures come from a study by the Center for Management Buyout Research in Great Britain. The most detailed research on private equity arguably pertains to the U.K. market, given that this country has had a private-equity association for some time and that the need for support is especially great because of intense industry criticism.

14. Private equity has brought more than financial expertise to the table for some time. AEA Investors, one of the earliest buyout groups, made it a practice to take advantage of the managerial talent of its wealthy investors and to put them on the boards of its portfolio companies. Among the former executives who invested with AEA are Bill Hewlett of Hewlett-Packard, Irving Shapiro of Du Pont, Reginald Jones of GE, and Walter Wristen of Citicorp (Eden 2007, 92).

15. Explaining the dramatically different experience of taking a company public before and after Enron, Domino's CEO David Brandon said the process is now more difficult because independent directors have "a bunker mentality," and there are more "moving parts" owing to new committee structures, the Sarbanes-Oxley Act, and the significant fees paid to auditors ("Private Equity Players Hit the Big Time" 2007).

numbers.[16] These higher costs make the potential upside of participating in private companies more attractive. However, working with private-equity groups is not for everyone because it requires putting a substantial amount of personal capital at risk and becoming subject to close oversight by buyout directors.

Private equity's importance for supporters of markets, competition, and capitalism should be clear: the active investors of such private-equity groups are natural, beneficial, and evolutionary extensions of markets. Not only are they a natural outgrowth of market processes, but they act as powerful catalysts to make markets and firms operate more efficiently to better serve consumers and to generate more wealth. Although they will never fully eclipse public companies, they offer a competitive alternative and provide innovative organizational, strategic, and financial ideas.

Creative Destruction: Joseph Schumpeter Meets Henry Kravis

One of the bigger image problems that capitalism and LBOs share is that they are commonly viewed as destroying companies and jobs as opposed to creating companies and increasing jobs. This view contrasts with the more positive image of venture capital, another form of private equity, which focuses on financing startups. The process of investing capital with entrepreneurs to create new enterprises has the appearance of a purely positive endeavor. Yet the fact is that these startup entrepreneurs, by providing better and cheaper products, have themselves "destroyed" many industries. The rise of venture-capital-financed Apple Computer, Microsoft, and Dell Computer companies, for example, "destroyed" much of the computer industry that preceded them, but to the great benefit of consumers and society in general.

In a world of scarce resources and choice, competition entails creation and destruction. Adam Smith observed in 1776 that the invisible hand of competition moves resources to more valued uses and ensures that the consumer's interests are served. The discipline of competition is the best check on resource waste and fraudulent business practices. Competition encourages entrepreneurs, owners, and managers to innovate—to think of better ways to organize business, to create more value with fewer resources, to combine resources more efficiently, and to lower prices.

The Austrian economist Joseph Schumpeter highlighted the value of destruction in the maintenance of a vibrant competitive economy when he identified the "perennial gale of creative destruction" (1962, 84) as the source of innovation, productivity improvements, and economic growth.[17] Fueling this capitalist dynamic, according to

16. "As noted by the Committee on Capital Regulation, U.S. companies are staying private rather than face the dreaded one-two punch of the U.S. plaintiffs' bar and the SEC's regulatory juggernaut" (Macey 2007).

17. Sad to say, *creative destruction* is not a phrase that many are willing to stand behind because in our overly sensitive age the term *destruction* overshadows the term *creative*. In *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (2007), George Mason University economist Bryan Caplan turns the

Schumpeter, are entrepreneurs who continually shake up the corporate landscape and "destroy established enterprises by coming at them with new products, fresh competitive techniques and innovative technology."[18] For Schumpeter, capitalism is a dynamic, evolutionary process—competition does not take place across only a few dimensions, such as price and product quality, but also occurs across business processes and organizational structures. The relevant problem, he declared, is not "how capitalism administers existing structures," but "how it creates and destroys them" (84). Private equity groups offer precisely this type of competition to the traditional public-company organizational structure. The ownership transformation brought about by LBOs represents an organizational innovation that deals effectively with the information and incentive problems that handicap many public companies.

Law and economics professors Ronald Gilson and Reiner Kraakman came to a similar conclusion when they studied a previous wave of corporate takeovers and LBOs in the "Barbarians at the Gate" era of the 1980s. They observe that "revolutions are profoundly unsettling" and that the "junk-bond financed bust-up takeovers" of the 1980s were especially threatening to the established order because they represented "outsider, not insider capitalism" (2005). The defensive response from the established order—incumbent corporate executives, the media, and politicians—was to seek legal and regulatory changes that helped to shut down the market for corporate control.

Edmund Phelps has recently highlighted the value of Schumpeterian "dynamic capitalism" and suggested that a "tremendous confusion is created by associating 'capitalism' with entrenched wealth and power" (2006). According to Phelps, Schumpeter and his Austrian contemporary F. A. Hayek saw capitalism as "opening up the economy to new industries, opening industries to start-up companies, and opening existing companies to new owners and managers." The entrepreneur, "a new comer, a parvenu who is an outsider," is the agent of change. Today private-equity groups are indeed catalysts; yet, to some, the immense wealth they have accumulated and their institutionalized approach to overhauling companies make them appear entrenched.

Understanding that competition, the dynamic and multidimensional process of creative destruction, is natural and economically beneficial is an important step in appreciating capitalism and private-equity groups. In a world of scarce resources and changing consumer preferences and technology, it is critical to have catalysts such as private-equity groups to challenge the existing order and to rejuvenate the economic

tables by suggesting that the bias against downsizing or "creative destruction" is one of four areas in which voters support ideas and policies that are contrary to their interests—in other words, that are irrational.

18. "Managers who fail to innovate—who think that they can stand pat on winning formulas—will find instead that they are, in Schumpeter's words, 'standing on ground that is crumbling beneath their feet,'" states Dan Seligman (2007) in his review of Thomas McCraw's biography of Schumpeter, *The Prophet of Innovation*.

system. They are an important form of competition that is fully consistent with evolutionary capitalism. Just as they are currently the product of market forces, they too in their turn will be shaped, destroyed, and superseded by new organizational forms that will put resources to work more productively and generate additional wealth.

The Private-Equity Group versus the Public-Company Model

Private-equity and public-equity business models differ fundamentally. These differences are magnified when private equity is not a stand-alone company, but part of a large network of companies under an LBO organization (for example, KKR, Blackstone Group, or Carlyle Group). These buyout groups are flourishing and creating a highly competitive business model. Globalization and technological change have put a premium on companies' ability to be operationally and financially flexible and dynamic. The stronger and more incentive-driven governance structure that buyout companies build into their portfolio companies is especially well suited for this increasingly dynamic and competitive environment.

Solving the Governance Problem by Linking Ownership and Control

> Where we come from we think the public model is broken from a governance and capital structure standpoint.
>
> —Michael Goss, CFO, Bain Capital, qtd. in Joseph McCafferty's "The Buyout Binge"

Active investors in general and private-equity groups in particular succeed in large part because they solve the age-old corporate-governance problem: separation of ownership and control. Public companies tend to be owned by a large number of small, dispersed shareholders and managed or controlled by executive teams who often have little ownership. Consequently, an inherent conflict arises between shareholders whose interests lie in maximizing the company's value and managers who, with little equity at stake, may seek other benefits, such as long-term control without pay for performance, country club memberships, private jet planes, and a bigger (but perhaps not profitable) business empire.

How can the conflict between owners and managers over the control of a public company's resources best be resolved? Traditional corporate-governance principles suggest that the board of directors and large institutional investors, such as pension and mutual funds, have the responsibility to look after shareholders' interests. Yet, as history has shown, neither group has the incentive, information, or resources to step in and align management and shareholders' interests. Nor has the regulatory response elicited by the Enron, Worldcom, and other instances of massive internal control failure proved effective. Indeed, the mandate for "independent directors" found in the Sarbanes-Oxley Act and the stock exchanges' listing requirements may make the board an even weaker monitor.

A defining feature of private equity is that it is *ownership centered:* putting personal capital at risk aligns the key parties' interests. Private-equity general partners put significant amounts of their personal wealth into the funds they manage, and the managers of companies taken private are generally required to put significant "skin" into the game. A Boston Consulting Group study found that this contribution amounted "to an equivalent of as much as one to two years of salary invested in the business"(Meerkatt and Rose 2006, 9). This ownership stake, when combined with more focused performance standards imposed by private-equity partners, rarely exists in public companies. With all the major decision makers holding direct stakes in the company, trust and team building come naturally and more quickly, and, unlike in many public companies, executive-pay issues do not divert the firm's time and attention.

The compensation principle at buyout groups is clear and simple: a 20 percent share of the value created and captured goes to the limited-partner investors, who provide approximately 2 percent of the funds raised.[19] As Scott Sperling, copresident of Thomas H. Lee Partners LP explains, "Around 90% of the compensation [that] the management team get[s] at our companies is driven by the performance of the equity value. The big numbers they make are all based on how the investment does. The alignment of management's interests and our interests is pretty absolute" (qtd. in Carey 2007).[20]

The upside rewards from an executive's significant ownership stake can be many times greater than that achievable at a public company, especially if a company is taken public. For example, Mickey Drexler, the former CEO of Gap, was encouraged to take a 12 percent stake in J. Crew when he was hired to run the then poorly performing company. Under Drexler's and the private-equity sponsor's leadership, J. Crew stock has risen nearly 90 percent since its June 2006 IPO, providing significant upside for those with equity (Rosenbush 2007a). Joseph Welch was offered an opportunity to run ITC Holdings Corp., the private electric transmission company that KKR bought in 2003, provided he invest about $1.5 million for a 1.7 percent stake. Seventeen other executives ITC hired were also required to make substantial personal investments in the company. As one ITC executive observed, "It's the greatest team-building exercise you can have. And that, fundamentally, in my mind, is why KKR is so damned successful: They invest in and motivate people—they align people" (qtd.

19. The U.K. buyout group uses a rule of thumb that executives provide 2 percent of its funds. Based on this formula, the firm's one hundred executives need to find about €220 million, or €2.2 million each (Arnold 2007a).

20. Glenn Youngkin, a partner at Carlyle, puts it another way: "We tell managers, 'Your job is to build a great company and create value. To create value, Ebitda has got to go up, debt has got to come down. At the end, if we can get an exit value where we all make money then you will make money. By the way, your downside protection on your equity is zero" (qtd. in Carey 2007).

in Teitelbaum 2007).[21] ITC went public in July 2005, and as of June 2007 Welch's stake was valued at more $30 million. KKR generated five times its invested proceeds. Along with the upside rewards, however, is the exposure to downside risk, which primarily takes the form of nonliquid stock managers' hold prior to the company's going public or being purchased. Hence, managers' incentives are aligned with private-equity investors' interests.

Clearer assignment of responsibility and greater upside potential are important in attracting talent into private-equity portfolio companies. The buyout consortium that took the Dutch publications company VNU private in 2006 is reported to have used $100 million in equity to lure David Calhoun from his position as chairman of General Electric Co. to be CEO of the new company. Cristóbal Conde, the chief executive of the technology services company SunGard Data Systems Inc., has a stake of more than 2 percent in the company, which was taken private in a $11.3 billion buyout in 2007 (Kranhold and Lublin 2006).

What has been the experience of private-equity organizations and their general partners? Blackstone's $7 billion IPO in June 2007 disclosed that its CEO Steve Schwarzman, who holds a 23 percent stake in the company, earned nearly $400 million in 2007. Noting how this reward was consistent with investors' interest and only a small portion of the money he made for them, the executive compensation specialist Laura Thatcher of Alston & Bird told the *Financial Times,* "The fact that he is drawing down $400 million a year is the ultimate in performance based compensation. Public companies should take a lesson from this" (qtd. in Guerrera, Politi, and White 2007).

Linking ownership with control and having a large, active, and highly interested investor in the boardroom are defining characteristics of private-equity firms and important ingredients in solving the governance problem and creating wealth. The alignment of interest with ownership is a self-driven and highly effective means of holding managers accountable and getting them focused on creating value. The corporate-governance machinery of public companies, by comparison, has become more compliance-oriented than value-oriented because directors often have neither an incentive nor the information to guide or challenge CEOs.

The Disciplinary Role of Debt

A key step in an LBO is replacing public-company equity with debt from a number of sources—the share of debt generally going from less than 50 percent to more than 65 percent.[22] This financial restructuring is critical to concentrate equity in fewer hands

21. To finance his investment, Welch is reported to have resorted to emptying "his savings account, mortgaging his house and taking out a loan" (Teitelbaum 2007, 38).

22. Henry Kravis of KKR has noted that that the level of debt has fallen. "In 1987, the average deal was 93% debt and 7% equity. In 2006, the average deal had 33% equity and 67% debt" (qtd. in Sender 2007).

and hence to make managers more accountable and to increase the rewards for value creation. Less appreciated is debt's role in focusing managers' attention on increasing the firm's operating cash flow, selling unproductive assets, and curbing unprofitable investment.[23] This powerful incentive mechanism is one of private equity's key sources of success, and it is especially critical for mature companies.

The conflict between managers and shareholders can be especially destructive in mature public companies with steady revenues but few profitable investment opportunities. Without the discipline of needing to return excess capital to shareholders or debtholders, managers may use accumulated cash to fund unprofitable investments, such as value-destroying mergers. As Pettit has noted, studies show that companies, including technology companies such as Microsoft, are "sitting on mountains of cash, much more than they need"; "holdings at NYSE- [New York Stock Exchange] and Nasdaq-listed companies topped a record $2.7 trillion in 2005, and they are growing at 24% annually" (2007). Moreover, risk aversion at the executive and board level may translate into a conservative capital structure with excess cash.

LBOs are especially well suited to suppress the temptation that free cash flow creates—what Michael Jensen (1986) calls the "agency cost of free cash flow."[24] The large amount of debt in a company's capital structure after a buyout entails a legal contractual obligation for the firm to pay it down. This requirement is more binding and meaningful than a promise to increase dividends or to implement a share-buyback program. Forced to make debt payments, management must quickly gain strategic clarity, focus on the core business, cut costs, and increase revenues. Less surplus cash on hand means fewer resources to waste and to divert the managers' attention.

Public companies apply this financial strategy with "leveraged recaps"—that is, recapitalizing their balance sheets by borrowing and using the proceeds to buy back stock or issue a special dividend. Research demonstrates this strategy's powerful incentive-alignment effect. For example, financial economist Karen Wruck (1998) shows how Sealed Air Corporation created an urgency for organizational change and sustained performance improvement by borrowing almost 90 percent of its common stock's market value to pay out a special dividend to shareholders. Yet despite this strategy's known value, few public companies take advantage of it. Although the value of LBOs reached $104 billion in the first quarter of 2007, leveraged recaps were valued at only $8 billion.

This outcome may not be very surprising. LBO groups' willingness and ability to have their portfolio companies operate with more debt spring from the partners' much more active involvement in the company as well as from their and the man-

23. Within months of taking private Toys 'R' Us, the KKR team is reported to have taken "drastic action, sanctioning the closure of 75 stores, more than 10% of the group's US foot print" (Guerrera and Politi 2007a).

24. "Agency costs" are the monitoring, contracting, and governance costs involved in aligning managers' interests with owners' and the value lost when that alignment is poor.

agement's strong ownership interest. This governance structure is capable of handling the greater stress of high leverage. Should a portfolio company with good long-term prospects experience financial stress or see profitable investment opportunities, the buyout group, which is constantly in the capital markets, can raise funds efficiently. The situation differs greatly at public companies, which lack active owners on the board and whose management has little equity. Consequently, relative to a buyout portfolio company, a public company is organizationally weak and less able to withstand the financial and governance stress associated with high leverage.

Active, Value-Maximizing Boards

> I like to define private equity firms as "organizations that run governance systems that run businesses."
>
> —Michael H. Jensen, in "Morgan Stanley Roundtable on Private Equity"

Critical to private equity's success in transforming companies—accomplishing the hard work of aligning incentives, attracting the right managerial talent, making necessary operational changes, getting the capital structure right, and shouldering higher levels of debt—is having what University of Chicago economists Robert Gertner and Steve Kaplan (1996) call a "value maximizing board." These boards' composition and operation offer insight into why public companies find it so difficult to replicate what private-equity companies do. Gertner and Kaplan's research shows that the greatest distinction between boards of companies that go public after an LBO (and where the private-equity partnership maintains an equity stake) and boards of similar public companies (without an LBO-group stake) is that the former control larger stakes. In addition, their research shows that buyout-firm boards are smaller, and a premium is put on finding board members who have industry knowledge.

The emphasis on ownership enables buyout groups to go beyond the standard public-company board model and to deal with the information- and incentive-alignment challenges at the director level. This fundamental gap between public and private companies has ironically been accentuated by regulatory constraints. For example, today's compliance-focused, public-company, governance model has been shaped by the Sarbanes-Oxley Act, exchange-listing rules, and SEC insider regulations (for large shareholders). The rise of "independent" directors with little or no equity stake and often with little industry experience is one of the perverse outcomes of this regulatory framework (about which I say more presently). These rules make it difficult if not impossible for a public company to replicate private equity and create a value-maximizing board of highly informed, focused, and interested directors.

The value that private-equity groups see in preserving this organizational structure even in the public markets was indicated March 2007 when Blackstone Group chose an LP structure to float a portion of its management company. The LP structure helps to preserve the group's tax, regulatory compliance, and control advantages. For example, its board will not have to include a majority of independent directors, as do listed corporations. Blackstone wanted to capture the benefits of becoming a publicly traded company, but it also wanted "to preserve the elements of our culture that have contributed to our success as a privately-owned firm" (Blackstone Group L.P. 2007).

As John Moon, a partner at the private-equity firm Metalmark Capital LLC, has observed, when both board members and managers are owners, the alignment of interests makes for a healthier and more productive working relationship: "Indeed, the essence of the private equity model is better-informed investors interacting with more highly motivated executives in a closer working relationship with more open discussion at the board level. In monitoring investments, PE [private-equity] investors work with CEOs, effectively serving various capacities that range from executive coach to consultant to investment banker, providing ongoing advice, analysis, and when necessary, additional capital" (2006, 80).

The fundamentally different ownership structures and board compositions of private-equity portfolio companies and public companies have major repercussions for operating, governance, and financial performance. Significant ownership interest, industry expertise, and intimate involvement in the company are critical in driving the governance transformation that public companies undergo when they are taken private. This factor helps to explain why buyout companies tend to run more smoothly with less manager-director conflict, drive substantial operational improvements despite carrying significant debt, and go public at a value significantly greater than their previous public-company value.

A Regulatory and Legal Environment That Spurs Active Investors and Handicaps Institutional Investors

The rapid rise of active investors has stimulated a deeper look into how the regulatory and legal environment has shaped the battles for corporate control and prevented public companies from enjoying the advantages of having large, outside, and interested shareholders on their boards.

April Klein and Emanuel Zur (2006) and Marcel Kahan and Edward Rock (2007) have identified a number of restrictions on mutual funds that limit their ability and incentive to scrutinize portfolio companies closely and thus leave a vacuum for buyout companies and hedge fund activists to fill. These restrictions include:

- Diversification requirements in the Internal Revenue Code and the Investment Company Act of 1940, which restrict a large portion of a fund's assets from owning more than 10 percent of any company's stock and prevent the fund from investing more than 5 percent of its assets in any stock.
- Enough capital in open-ended funds to cover redemptions. Unlike active inves-

tor funds, open-ended funds cannot restrict investors from exiting, which means their capital is more liquid and less capable of making longer-term, value-increasing investments.

- Restrictions on short-selling securities and on leveraging the funds' portfolios under the Investment Company Act of 1940.
- Pay-for-performance restrictions imposed by the Investment Advisors Act of 1940 on mutual-fund managers that require compensation to be based on a percentage of the fund's total invested capital, not on a percentage of the funds' profits, as with active investors.
- Requirements to disclose semiannually the lists of the amount and value of securities held, which make it more difficult to accumulate positions discretely, compared to other investors.

Klein and Zur (2006) found that these restrictions, as well as conflicts of interest between fund managers and fund beneficiaries, are the chief reasons why institutional investors such as mutual funds and pension funds do not play a more active role in monitoring the managers of public companies. The upshot is that they cannot position themselves as large shareholders (with more than 10 percent stakes), nor can they profit from the additional value they help to create.

Private equity's rise has been in part a response to the weakness of institutional investors' monitoring ability because LBOs have been an effective mechanism to align management's interest with the objective of maximizing the company value. For companies that remain public, restrictions have spurred hedge-fund activists to step in, but in general the rules have discouraged the involvement of long-term outside investors with substantial stakes. Ironically, this situation has been made worse by the Sarbanes-Oxley Act and the exchange-listing rules,[25] which have elevated "independent" directors at the expense of informed and interested outside directors with significant equity stakes. For example, the Sarbanes-Oxley Act requires that audit committees be composed entirely of independent directors who, among other requirements, must hold less than 10 percent of a company's stock.

This situation is ironic, given that these rules and regulations were meant to diminish corporate governance abuses, such as fraud and self-dealing, which active investors sitting on boards have the greatest incentive and best vantage point to police. In commenting on these rules, Charles Ferenbach, cofounder and managing

25. Under New York Stock Exchange rules, listed companies must have a majority of independent directors, and a director is independent if he has no "material" relationship with the company, including directly as a partner or shareholder. The compensation and audit committee (as governed by the Sarbanes-Oxley Act) must be composed solely of independent directors. See New York Stock Exchange Group, "Listed Company Manual" at http://www.nyse.com. Similarly, under NASDAQ rules, the majority of the board must consist of independent directors, and a director will not be considered independent if he is a 20 percent or more controlling shareholder, among other things. Although the audit committee must be made up of independent directors, compensation provided to the CEO must be approved by an independent compensation committee or a majority of independent directors. See NASDAQ, "Listing Standards and Fees," at http://www.nasdaq.com.

director of the private-equity firm Berkshire Partners, observes that the regulations "present a big problem for us when we take a company public; and if we could find a way to loosen them, private equity firms could play a more meaningful role in the governance of public companies" ("Morgan Stanley" 2006, 37).

Limited Fund Life and the Discipline of Raising New Funds

Another important distinguishing aspect of the organizational structure of private-equity groups compared to that of public companies is the limited life of their funds and the necessity of returning to the marketplace to raise new funds. Under the partnership structure of LBO groups, limited partners such as institutional investors commit capital to general partners for as long as five to seven years. The general partners are obligated to return this capital plus a profit—that is, if they want to raise subsequent funds. Moreover, a general partner will not receive his cut of the profits until the limited partners are returned their capital.

The obligation to return capital with a profit provides a disciplinary force with no equal in the public-company model. Like the discipline provided by debt, the obligation to disgorge cash to investors focuses general partners' minds on creating and harvesting value. As Henry Kravis of KKR notes, harvesting is the difficult part: "Any fool can buy a company. You should be congratulated when you sell" (qtd. in Sender 2007). As I demonstrate shortly, investors scrutinize an increasing array of investment alternatives and allocate a growing portion of their funds to private-equity groups because on a risk-adjusted basis this class of investments has generally achieved attractive returns.

The limited but multiyear life of buyout funds means that the investment horizon of a company taken private can be considerably longer than that of the average public company, which is under pressure to meet financial targets quarterly. The quarterly focus to "hit the numbers" has been associated with some of the more significant corporate-governance failures—for example, at Enron, WorldCom, and other public companies that overstepped the law to manage and even manufacture earnings. Moreover, as management gurus Geoffrey Colvin and Ram Charan have pointed out, public-company managers spend significant amounts of time "trying to placate and massage the public markets." Talking to shareholders, analysts, and the news media is big part of a public-company CEO's job, but it is also a "massive distraction from the company's operations" (2006). These distractions and perverse incentives disappear when a company is taken private.

To raise follow-on funds successfully, principals or general partners must achieve respectable returns for existing investors, and do so in a way that maintains a reputation for honest dealing. This requirement applies especially to private-equity investment, given that it locks up the limited partners' capital for five to ten years, whereas shareholders in public companies can exit an investment almost at will. Locking in investor funds is essential for making the difficult but necessary operational and financial changes needed to create long-term value and for providing the flexibility to ride out tough times. It also entails an illiquidity risk for investors. To mitigate this risk, investors look to the general partners' reputation for consistently generating returns and their willingness to coinvest alongside the limited partners.

A recent trend that may weaken the incentives created by limited-life funds is for private-equity firms to take a portion of their management company public. Among the stated goals of creating publicly traded entities is to create more stable institutions with "permanent capital" and thus to institutionalize the business. This move includes providing a mechanism for founders to cash out and hand the reins to younger partners. In February 2007, Fortress Investment Group LLC, a nine-year-old manager of hedge funds and private-equity funds with about $30 billion in assets, sold a minority interest. In June 2007, Blackstone, the twenty-two-year-old global-asset manager with a big buyout business sold off a 10 percent stake on the New York Stock Exchange.[26]

It is too early to judge whether shareholders' interests in a private-equity management company will conflict with that of the private-equity fund's limited partners. Blackstone's prospectus warns potential investors that its "guiding principle" is to return cash to private investors in its funds rather than to pay dividends to shareholders. Yet because Blackstone's senior managers and other employees retain ownership of almost 75 percent of the management company's equity, their interests are also aligned with the shareholders' interests.

Global Platforms for Combining Resources and Rationalizing Capacity

Private equity's growing international profile reflects the viability and adaptability of the model's ownership and organizational structure. The larger buyout groups, such as KKR, Texas Pacific Group (TPG), Blackstone, and the Carlyle Group, have operations across the globe. Despite these groups' looking like large conglomerates with wide-ranging businesses, their partnership structure, finite fund life, and reliance on ownership incentives indicate that they are nearly the opposite—highly focused, bottom-line businesses that operate in a decentralized fashion with lean staffs. Each portfolio company, for example, is operated as a separate, stand-alone entity, which is critical to maintain accountability and focus, and prevents the cross-subsidization and governance pitfalls that often plague conglomerate businesses.

The rise of $10 to $20 billion megafunds has enabled buyout groups to build large global platforms for leveraging knowledge, relationships, capital, and other resources, a strong indication that their governance structure is scaleable. Moreover, the investment offerings have expanded beyond private equity to include real estate, mezzanine finance, distressed debt, and hedge funds. Today the bigger, well-known

26. The $31-a-share IPO, which raised more than $4 billion and valued Blackstone at more than $33 billion, is the largest U.S. IPO since 2002 (Flaherty and Zuill 2007).

firms have become global alternative-asset platforms. They consequently have extensive networks of relationships around the world that can be leveraged to help their portfolio companies build stronger businesses quickly. This result may be achieved with the addition of the right manager or director, more capital, or mergers or partnerships with a complimentary business. For example, KKR has investments in forty companies across more than ten countries; it operates in eleven sectors, including health care, technology, media, retail, and the hotel/leisure industry.

The tremendous restructuring challenge in today's increasingly competitive and growing global marketplace puts a premium on companies' ability and discipline to rationalize capacity and move resources where they can be used more productively. Thus, private-equity firms are often involved in strategies to roll up sectors by buying and building businesses. For example, Blackstone owns substantial assets in the amusement park business and has a growing global hotel franchise with the recent $25 billion buyout of Hilton Hotels Corp. It is also a premier real estate investor. In February 2007, the firm closed the $39 billion Equity Office Properties Trust buyout, the largest U.S. real estate deal.[27]

In 2005, DLJ Merchant Banking Partners bought Wastequip, which was founded in 1989 with "the objective of consolidating the equipment segment of the waste industry in order to better serve its rapidly consolidating customer base." With its new parent, Wastequip gained better access to financial markets and a lower cost of capital than it had as a stand-alone borrower. As a result, it was able to accelerate its acquisition program. The Carlyle Group, one of the consortium partners that bought Dunkin Brands (the parent company of Dunkin' Donuts) introduced the firm to one of its investors in Taiwan and now has an agreement for one hundred Dunkin' Donuts stores in that country (Colvin and Charan 2006). In commenting on a private-equity consortium purchase of TXU Corp., Texas energy utility, for a record-breaking $45 billion, the CEO John Wilder remarked that "the buyers bring a network of individuals and capabilities that a company like TXU couldn't construct on its own," and he went on to note that "we believe that they [the buyout group] will be a catalyst for innovation" (qtd. in Politi 2007).

Private-equity organizations are both taking advantage of globalization and driving it. By concentrating ownership and increasing accountability, buyout groups can build stronger and more competitive business across the globe and create significant wealth for investors. The network of relationships across the alternative-asset management model helps to strengthen the economic ties among countries and quickly makes financial, intellectual, and technological resources available to localities where they are in short supply, but are critical for business success.

As highlighted in table 1, the public-company model is often at a distinct dis-

27. Jonathan Gray, Blackstone's senior manager, director, and cohead of real estate, has been called "the global king of real estate." In addition to Hilton, the Blackstone stable of hotels includes Doubletree, Embassy Suites, Hampton Inn, Homewood Suites, and the Waldorf-Astoria Collection (Biltz 2007).

advantage compared to private-equity firms. It is little wonder that public companies are incorporating a number of private-equity operational, financial, and governance practices, such as requiring executives to hold substantial stakes in the company, increasing debt, returning cash to shareholders, shedding noncore assets, and separating the chairman and CEO positions.[28] However, natural as well as regulatory limitations generally impede changing a public company's capital, ownership, and governance structure. Blackstone's IPO and partnership structure suggests a new wrinkle for getting around these limitations.

Evidence on Funds and Trends in Returns

Worldwide there are 2,500 to 3,000 private-equity *firms*—buyout, venture capital, and other types. The vast majority consists of LBO groups located in the United States. Galante's Venture Capital and Private Equity Directory puts the number of LBO groups at nearly 2,000. Another way to view the industry's size is in terms of the number, value, and size of individual *funds*. Private Equity Intelligence (PEI) tracks data for more than 3,400 private-equity funds, which, it claims, represent about 70 percent of the total universe of private-equity funds (2007b, 1). According PEI, 684 private-equity funds raised $457 billion globally in 2006, which compares to $315 billion raised in 2005.[29]

It is estimated that the global stock of available private-equity capital—all funds committed to private-equity groups globally, including those as yet uncalled as of June 30, 2006—grew to $610 billion in 2006 (PEI 2007a, XX). This is a significant and growing pool of capital, yet it represents about only 2.5 percent of the more than $24 trillion engaged in global equity markets.

Besides the growth in the number and value of groups, the size of private-equity funds has grown rapidly. Global megafunds (more than $5 billion) have been raised by established buyout firms with established records of success. These firms include:

Blackstone ($20 billion)
Goldman Sachs Private Equity ($19 billion)
KKR ($16 billion)
Carlyle Group ($15 billion)
Apax Partners ($8.5 billion)
Thomas H. Lee Partners ($9 billion)

28. Margaret Ewing—the former finance director of BAA, the U.K. airports group, and since 2005 a nonexecutive director at Whitbread, the U.K. leisure group—recently pointed out that shares in the latter company have doubled during the past year because "new management changed the strategy after asking: 'What would private equity do if it acquired us?'" (qtd. in Hughes 2007).

29. Communications with Mark O'Hare, managing director, PEI, January 2007.

Table 1
Publicly Traded Company versus Private-Equity Group

Aspect	Publicly Traded Company	Private-Equity Group
Ownership	Dispersed shareholders	Concentrated shareholders
Role and Composition of the Board of Directors	Monitoring by part-time, "independent" directors with little if any ownership in the firm or industry expertise	Granular monitoring and participation by nonindependent, active investors with industry expertise and equity stakes
Managerial Compensation	Weak pay-for-performance links and negligible ownership stake	Strict pay-for-performance links and substantial ownership stake
Management Focus	Earnings and managing earnings on a quarterly basis	Cash flow, value creation, and harvesting value
Communication with Capital Markets	Quarterly, at times confrontational	Expert, constant interface with capital markets
Mergers and Acquisition; Deal Structuring	Tendency to pay too much	Core skill; tendency to pay lower premiums
Time Horizon	Quarterly	Five to ten years
Managerial Discipline	Dividends, discretionary buybacks	Obligation to pay back debt; requirement to return funds plus a profit to limited partners and to raise new funds
Network of Resources	Limited to a company's business units	Extensive and increasingly global network of financial, operational, and strategic resources

An important indicator of private equity's legitimacy and long-term success is firms' ability to raise successive funds—in other words, to return to the market to raise capital from new and existing investors. According to Blackstone, more than 70 percent of the fifty largest corporate and public pension funds that invest in alternative assets have invested in its funds. Many of these investors must be pleased with the funds' performance, given that about 85 percent of the total capitalization invested in Blackstone's funds since 1987 comes from investors that have invested in successive funds.

To induce investors to commit significant amounts of capital and to do so repeatedly requires demonstration of a record of solid returns in bad years as well as good ones. A key finding in research by Steve Kaplan, a professor at the University of

Chicago's Graduate School of Business, and Antoinette Schoar, a professor at MIT's Sloan School of Management (2005), is the strong persistence of returns across funds raised by individual private-equity partnerships—performance that improves with partnership experience. They conclude that better-performing funds are more likely to attract additional capital and to raise larger funds. Moreover, this performance differs from that of mutual funds, for which persistent performance is less common.

Collecting, measuring, and interpreting private-equity performance data has been a challenge in part because privately held investments are exempt from the disclosure requirements for public companies. This exemption has given the asset class a certain mystique, but it has also generated controversy. Kaplan and Schoar found that private equity on average outperformed the S&P 500 on a gross basis, but when adjusted for fees, venture funds outperformed the market, and buyout funds underperformed. In the Morgan Stanley Roundtable on Private Equity (2006), Kaplan indicated that reported returns to private-equity funds do not take into account any of the gains to the sellers in private-equity investments, which, especially in the case of auctions, often represent substantial premiums.[30]

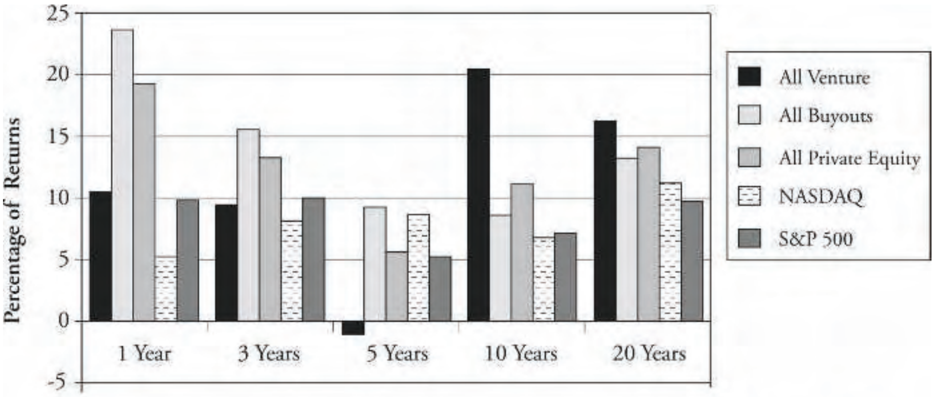
Kaplan and Schoar's finding of large variation in realized fund returns across time and across funds, as well as the persistence of returns, suggests why capital continues to flow into private equity despite the less-than-spectacular average returns. The growing size and number of megafunds result from these dynamics as firms with better organizations and performance records more successfully attract the financial and human capital necessary to expand the business.

Other research indicates a more positive picture of performance. According to Thomson Financial and National Venture Capital Association, which look at underlying cash flows after fees and carried interest on a one-year, three-year, five-year, ten-year, and twenty-year basis, buyouts have outperformed the NASDAQ and S&P 500 (2007, 2) (see figure 3). Thomson's recent quarterly numbers show that rate-of-return performance for buyout firms jumped from 19.4 percent to 24.5 percent between the end of the third quarter 2006 and the end of the fourth quarter 2006.

In a study of more than 320 exited U.K. buyouts between 1995 and 2004, the Centre for Management Buyout Research found an average return of 22.2 percent, net of market index returns (Wright, Jensen, et al. 2007, 1). Another performance measure is provided by indexes that track listed private-equity investment vehicles. The LPX50, a European index created by the Swiss company LPX Gmbh, outperformed MSCI World, NASDAQ, and FTSE indexes on an absolute and risk-adjusted basis during the 1993–2006 period (PEI 2007b, 3). The index covers the fifty largest

30. Kaplan uses as an example KKR's purchase of Disney RJR Nabisco. KKR paid $30 billion for the debt and equity of the company, whose enterprise value was about $17 billion as a public company. Paying such a high price in the heated auction, KKR and its investors ended up with a low return. "In that deal, KKR effectively paid out the entire value added to RJR's public shareholders—something on the order of $13 billion" ("Morgan Stanley" 2006, 16).

Figure 3
U.S. Private-Equity Performance



Note: Thomson Financial's U.S. Private Property Performance Index is based on the latest quarterly statistics from Thomson Financial. The investment horizon is through September 30, 2006. Thomson Financial calculates all returns from the underlying cash flows. Returns are net to investors after management fees and carried interest.

Source: Thomson Financial and National Venture Capital Association 2007.

listed private-equity funds and companies. PEI took this performance one step farther and compared it with the net return data it collects for more than 3,400 LP funds. It found that annualized LP returns exceeded the LPX50 index by 5 to 10 percent per year in most years from 1995 to 2004 (2007b, 3).

Private equity's performance can be more easily assessed when companies that are purchased and taken private are revalued at the time that they subsequently reenter publicly traded markets. A recent study by Harvard professors Jerry X. Cao and Josh Lerner examined 496 private-equity-led IPOs in the United States between 1980 and 2002 and found that these "reverse LBOs" have "consistently outperform[ed] other IPOs and the stock market as a whole," with "no evidence of deterioration of returns over time" (2006).[31] Such was the case when KKR acquired the supermarket company Safeway in 1986 for $4.1 billion. Four years later it took the company public, and today it is valued at $15.6 billion. Texas Pacific Group took the retailer J. Crew Group private in 1998, invested $115 million in equity, and made a sevenfold return on its investment with the company's June 2006 IPO.

Buyout groups' long-standing practice of maintaining ownership stakes in companies that they take public ("reverse LBOs") serves two functions:

- It signals a commitment by the buyout company that its interests are tied with new investors in maximizing the company's long-term value.

31. These results are consistent with the findings of a 1997 study by Robert Holthausen and David Larcker (1997), who also found that the "hybrid" organizations retained some of the organizational and board-structure characteristics of LBOs.

- It provides an option value or flexibility for the buyout group to participate in over the long term and to cash out when the circumstances are favorable.

The buyout group's stake often earns it a board seat, which provides a good position from which to monitor and offer services to the new public company. In May 2006, when KKR and its French partner Wendell initiated an IPO of the French electrical equipment firm Legrand, KKR sold only a small portion of its 37.5 percent stake because it anticipated further gains from its stake in the company (Guerrera and Politi 2007a). In 2007, three years after Bain Capital returned a significant portion of the Domino's pizza chain to the public market, the company announced a $1.85 billion recapitalization of its balance sheet (Beales 2007). Despite leverage having increased 6.9 times, the stock market sent the share price higher, and shareholders received nearly all of the proceeds. Having the right governance structure in place was important.

Research by economists Robert Holthausen and David Larcker (1997), who studied a sample of ninety LBOs that went public between January 1983 and June 1988, highlights how the ownership and governance advantages gained in taking a company private carry over when it goes public again. Their research on "hybrid" organizations found that

- The operating performance of reverse LBOs was significantly better than that of the median firm in their industry, and this superior performance continued at least over the first four fiscal years after the IPO.
- The mean and median percentages of equity owned by operating managers were 22.4 percent and 12.6 percent, respectively, which was more concentrated than in typical corporations.
- Three years after an IPO, a major shift occurred in board structure as nonmanagement capital providers were replaced by external directors with limited equity stakes.

The persistence of returns has been a key reason why institutional investors have been allocating a growing portion of capital to private equity. PEI indicates that the global average institutional allocation to private equity jumped from 7.1 percent in 2006 to 7.8 percent in 2007. This relatively small base leaves substantial room for growth, and PEI foresees 9.7 percent as the average target allocation (2007c, 1). Legendary investor David Swensen, who manages Yale's endowment, has been investing its money with private-equity groups since 1973. In 2005, almost 15 percent of the endowment's capital was invested in private-equity funds, in contrast to about 6 percent for most other educational institutions. Yale credits the "alternative-asset" class for the endowment's spectacular 22.3 percent return on investments in 2005. University endowments tend to be more aggressive investors in private-equity funds, but public and private pensions are moving in that direction. For example, CalPERS, the country's largest public-pension fund, with more than $210 billion in assets, commits more than $26 billion to private-equity funds.

Common Allegations Against Private Equity

The rapid growth of private-equity groups in size, power, and prestige has generated significant resentment, envy, and hostility. Private equity has become a lightening rod for controversy across the corporate landscape. The image of large, private, secretive financial entities taking popular consumer-brand companies such as Toys 'R' Us, J. Crew, Hertz, and Chrysler private is difficult for many to comprehend, if not plainly troublesome, especially when not long after taking the companies private, buyout groups sell them for much more than their initial investment. The news media tend to see the process as a combination involving fancy financial engineering, massive conflicts of interests, collusion, duped public shareholders, and huge job cuts.

Among a growing number of myths about and allegations made against private equity, four of the most common are:

- Management and buyout firms collude in decisions to go private at the expense of existing investors.
- Club deals, which involve a consortium of private-equity groups that purchases public companies, stifle competition.
- Buyout groups destroy jobs and create unemployment.
- The profits or "carried interest" of buyout groups' general partners represent a payment for services and hence should be taxed as ordinary income at a higher rate, 35 percent, not as a capital gain, at 15 percent.

Let us now assess these claims.

Allegation 1: Management and Buyout Firms Collude

> Corporate executives play a critical role in advising directors and shareholders on the merits of taking the companies they run private. Yet these same managers stand to make much personally from participation in leveraged buyouts that it's difficult to see how they can offer objective advice.
>
> — Breakingviews, "On Going Private," *Wall Street Journal*

All else being equal, buyout groups prefer that existing management stay when the company is taken private. The LBO transformation consists in great part in making these executives better managers by giving them a large ownership stake and by exposing them to the active governance of buyout groups. The appearance of a conflict is clear: managers are to a great extent hired as agents to look after shareholders' interests. That the very same managers perform better, create more value, and personally make more money after a company goes private does *suggest* that managers may be underperforming for public shareholders. Indeed, many critics of private equity, including money managers, have made this allegation, yet this reasoning is simplistic because it fails to take into account the more fundamental "agency" conflict between public-company shareholders and public-company managers; gives no credit to the buyout process for minimizing the conflict through ownership and active governance; and does not acknowledge the great difficulty public-company managers have in replicating private-equity value-increasing practices.

The gap between the premiums for management-buyout deals and corporate-to-corporate deals is often taken as evidence that corporate chieftains are colluding with buyout groups. Jerry Cao (2008) found that the average premium for buyouts is 17.25 percent, but more than 23 percent for corporate or strategic-sponsored deals. To the critics, this difference suggests that buyout groups are working with management to get a better deal. Yet a much stronger argument supported by Rene Stulz and colleagues (2007) is that one of private-equity groups' core skills is deal making—intense due diligence and careful valuation so as not to overpay. When a public company makes an acquisition, its shareholders, not its managers, bear much of the risk but have little control. In contrast, the alignment of buyout-group partners' wealth and their involvement indicate that they are likely to take considerably more care in the acquisition process.

Among the louder groups complaining about collusion have been institutional shareholders and money-management firms—despite their having received substantial premiums for their shares in going-private transactions. In some cases, this criticism reflects bewilderment about why the same public-company managers who take a company private and go on to raise its value could not have accomplished this end when the company was public to the benefit of its public shareholders. Commenting in January 2007 about his view of the "inadequate" proposed $26 billion buyout of Clear Channel Communications, Jeff Jacobowitz at the investment bank Robotti & Co. said: "[T]here's no reason that what management wants to do as a private company can't be done as a public company. That would give the upside to the public shareholders" (qtd. in Bary 2007). The underlying assumption is that public companies taken private are undervalued by the market, and this undervaluation is either the management's fault or the market's.

Besides failing to appreciate how fundamentally different private-equity and public-company ownership structures and hence management incentives are, those who make allegations about market undervaluation and collusion miss the fundamental role of competition. If the market undervalues a company or if the company is being acquired on the cheap, why wouldn't other value-focused investors (financial or strategic) step in? There are a growing number of active investors—other buyout firms, hedge-fund activists, and financial entrepreneurs such as Warren Buffett's'

Berkshire Hathaway. With more than two thousand LBO groups, the market for taking public companies private is highly competitive. Research supports this view. Dealogic's data indicate multiple bids for 29 percent of buyouts in 2006, compared to only 4 percent in 2005. For the first six weeks of 2007, 70 percent of the announced buyouts had multiple bids (Rosenbush 2007b).

Competition among buyout firms can be fierce at both ends of the market as groups race to put capital to work in the best deals. One of the most competitive deals saw the Blackstone Group go head to head with Vornado Realty Trust for Equity Office Properties Trust. The auction, which was orchestrated by Equity Office's chairman Sam Zell, saw the firm's value increase by $2.7 billion over ten weeks and three rounds of bidding (Breakingviews 2007). In February 2007, Blackstone came out on top, paying $39 billion. In May 2007, TPG and the Goldman private-equity firm paid $25.7 billion for Alltel Corp., the fifth-largest wireless firm. To pull off the deal, they beat out two other rival consortia: Blackstone Group/Providence Equity and KKR/Carlyle Group. The auction for Clear Channel began in October 2007 after Blackstone and Providence Equity Partners' bid was topped by that of Apollo Management and Carlyle. Thomas H. Lee and Bain Capital entered the auction later, pushing the bid 7 percent higher than the original bid by March 2007 and 34 percent more than the company's market value by mid-August.

During the past few years, hedge-fund activists have become increasingly involved in buyout transactions, both complementing private-equity firms and locking horns with them when hedge funds are public-company investors.[32] More than two hundred hedge-fund activists are involved in taking minority stakes (5 to 15 percent of equity) in public companies and attempt to get the management and the board to make value-enhancing decisions, such as buying back stock, selling noncore divisions, and removing managers (Haarmeyer 2007). As shareholders with substantial stakes, these active investors have strong incentives to make sure that the buyout process is open and competitive and that a full price is obtained. A few of the deals they have participated in include:

- Paulson & Co. helped to force Blackstone Group to pay a higher premium for the German chemicals company Celanese;
- Pirate Capital took Toys 'R' Us directors to court, claiming they failed to get the best price when granting KKR, Bain Capital, and Vornado Realty Trust permission to make a $7 billion buyout;

32. In 2005, Atticus Capital pushed Phelps Dodge Corp. to take shareholder-value-enhancing steps, including the selling off of business units. Private-equity firm One Equity Partners LLP and DC Chemical Co. Ltd. purchased one of these units, Columbia Chemicals Co. Blackstone Group got its start owing in part to Carl Icahn, who was attacking the steel and energy group USX. USX sold Blackstone 51 percent of its transport business, which was Blackstone's first deal (Smith 2005). Scott Sperling of Thomas Lee Partners has called the buyout/hedge-fund relationship "symbiotic," saying: "Activist shareholders have identified situations where full value has not been created, and accelerated the process of those companies' becoming available to the private equity industry" (qtd. in Paulden 2006).

- Knight Vinke Asset Management pushed the consortium that included Blackstone, Carlyle, KKR, and others for better terms in taking the Dutch publications firm VNU private;
- Polygon Investments threatened to block Fortress Investment Group's purchase of the United Kingdom's Telent unless the deal's terms were enhanced;
- Glenview Capital Management, one of the largest shareholders of the United Kingdom's NTL, held out for a higher offer from Providence Equity, Blackstone, and Cinven;
- JANA Partners raised its stake from 5 percent to 10 percent and thwarted what it perceived to be an undervalued buyout offer by One Equity Partners for tire and wheel maker Titan International in 2007.

More assertive board members are helping to make the market for corporate control increasingly competitive. Once a buyout offer is formally announced, the board of directors is required to make sure that the company is open to alternative offers for a fixed period. These "go-shop," or auction, periods may be from less than twenty days to more than a month, and boards are more likely than not to approve extensions. For a buyout to succeed, in most cases two-thirds of the shareholders must support it. Even offers with substantial premiums sometimes get voted down. For example, in January 2007, the buyout offer of Veritas Capital for prison operator Cornell Cos. was rejected—despite a 30 percent premium from the price before the rumors of a deal emerged. Similarly, independent board members of Cablevision System Corp. rejected a buyout offer—at a 25 percent premium—from the controlling Dolan family (Berman and McBride 2007).

Because many small, dispersed shareholders fail to vote on corporate policies such as buyout offers, larger block voters such as institutional investors can play a strategic role. Indeed, they are now doing so more frequently as institutional investors follow the lead of hedge-fund activists and demand better deal terms. Some of the more recent high-profile transactions include:

- T. Rowe Price Group Inc. opposed the KKR, Citigroup Private Equity, and hedge fund S.A.C. Capital Management LLC bid for Laureate Education Inc. at a premium of 11 percent. According to Bill Stromberg, director of equities at T. Rowe Price, "The prevalence and number of these below-full-market transactions convince us that we need to be more activist" (qtd. in Whitehouse 2007).
- Fidelity Investments opposed the Clear Channel Communications buyout proposed by Thomas H. Lee Partners and Bain Capital and backed by the Mays family, which runs and owns 7 percent of Clear Channel, the largest radio operator in the United States. With the backing of hedge fund Highfields Capital Management and other investors, Fidelity, with an 11 percent stake, was able to get the offer price increased twice and structured a deal that enabled it and

other investors to participate in any gain created through the going-private transaction.

- Franklin Resources, a mutual-fund company with a 5 percent stake in TXU Corp., said in July 2007 that TPG and KKR's offer of $69.25 per share was "significantly below TXU's current value" and that the company would have performed better if the takeover had not been announced in late February (qtd. in Politi and Brewster 2007).

The Clear Channel transaction joins stereo maker Harman International Industries and the United Kingdom's Countrywide in deals that have seen the buyout market evolve to include shareholder concerns. Creating what is referred to as "stub equity," buyout groups offer target shareholders a minority stake in the new private company. While sharing in the upside, existing investors face downside risk of illiquid stakes and lack of voice on the board.[33]

In sum, the dynamic, evolving market for corporate control makes it increasingly difficult for private-equity groups to collude with management. Competition in the form of a wide range of increasingly active and sophisticated investors serves as a powerful safeguard against collusion and against the taking of public companies private on the cheap. Are public-company managers at fault for not measuring up to buyout managers? Should they be expected to unlock value to the same extent? Competition between the two organizational forms is healthy, and public companies are wise to mimic private equity. However, the gap in ownership and governance structure between the two suggests that there are limits.

Allegation 2: Club Deals Stifle Competition

> [P]rivate equity features brutal competition and enormous dynamism.
>
> —Josh Lerner, "Government's Misguided Probe of Private Equity"

In October 2006, the U.S. Department of Justice (DOJ) sent letters to KKR, Silver Lake Partners, the Carlyle Group, Clayton Dubilier & Rice, and Merrill Lynch & Co. requesting information about their business practices. DOJ's concern was that private-equity funds formed clubs to facilitate "colluding," which would enable them to reduce artificially the bid prices of properties they sought to acquire. By collabo-

33. Clear Channel stub holders will have a 30 percent stake in the private company. Thomas H. Lee and Bain made another concession to put two independent members on the board and to "stop issuing themselves fees that are commonly paid for executing a deal." Under the KKR and Goldman Sachs deal structure for the $7.8 billion purchase of Harman, current shareholders have the choice to receive $120 a share in cash for a 17 percent premium or to exchange shares for a stake in the new private company. Stub holders are expected to gain some liquidity when an over-the-counter market develops (Berman 2007b).

rating to make a joint bid for a company, went the allegation, a club deal could prevent costly bidding wars and thus restrict competition. The DOJ's action served as a green light for the plaintiffs bar to file a class-action lawsuit in November 2006 against thirteen private-equity firms for joint bidding. European governments have made the same allegation. However, the Financial Services Authority of the United Kingdom has not deemed "club deals" a competitive problem.

A number of high-profile "club deals" have been made. All of them involve public companies that are large for buyout candidates. According to Dealogic, more than 40 percent of all buyout transactions valued at more than $1 billion are structured on a club basis (Berman and Sender 2006). In August 2005, a consortium of seven private-equity firms—Bain Capital, Blackstone Group, Goldman Sachs Capital Partners, KKR, Providence Equity Partners, Silver Lake, and Texas Pacific Group—acquired SunGard for $11.4 billion. In December 2005, a consortium of buyout firms purchased Hertz Corp. from Ford Motor Co. for $15 billion, and in December 2006 another consortium acquired Freescale Semiconductor for $18 billion. Finally, in February 2007, marking what may be the largest buyout to date, a KKR-led consortium announced that it had purchased the TXU Corp. for $43.8 billion.

Despite the continual press allegations of anticompetitive behavior, no "smoking gun" has been identified, and two years after DOJ's request for information, it had neither taken any action nor offered any explanation of its findings. On a superficial level, it may appear that competition is weakened if private-equity firms combine in consortia to submit bids for target companies because by definition there are fewer bidders. Yet this interpretation falls back on a mistaken focus on the number of competitors (and the number of a specific kind of competitor) instead of on the openness of the competitive field and the robust nature of competition among existing and new competitors.

The allegation that the consortia are anticompetitive seems compelling in large part because of the presumption that the atomistic or "perfect competition" model is either an optimal or relevant benchmark. This textbook economics construct, which is rarely mimicked in the real world, assumes zero transaction costs and thus an infinite number of buyers and sellers who prevent any entity from earning above-normal economic returns. When the real world is taken in to account, however, searching, coordinating, contracting, and monitoring costs are essential for understanding why firms integrate upstream and downstream, merge to gain economies of scale, and execute LBOs: they want to minimize transaction costs (the marketplace's expensive friction) and risk. In this light, private-equity groups combine to bid on target companies that may be too big or too risky for any one buyout firm to bid for on its own. Funds generally limit to approximately 15 percent the amount of capital that they can invest in any single opportunity. Pooling resources makes economic sense, and, indeed, by enabling bids that would not otherwise be made, the practice may actually increase competition. Economist Elizabeth Bailey reaches precisely this conclusion, noting that "there are numerous reasons why bidding consortia may have no effect on competition and may in fact lead to more aggressive bidding for companies on the auction block"(2007, 8).[34]

The economic logic of the practice is further demonstrated by its long history in the venture-capital industry, where the risk of investing in startups is high. Harvard economist Josh Lerner, a venture-capital expert, observes that although sharing or syndicating deals has costs, "extensive research has found that the benefits to society of deal sharing far outweigh the costs" (2007, 3). He compares the current antitrust investigation of private equity to the DOJ's misguided attempt to charge seventeen leading investment banks with anticompetitive conspiracy in connection with their collaborative practices. In dismissing these charges, Judge Harold Medina said practices were "nothing more, nor less than a gradual, natural, and normal growth or evolution by which an ancient form has been adapted to the needs of those engaged in raising capital" (qtd. in Lerner 2007).

As indicated previously, competition among private-equity groups may be intense, given the need to invest capital where it achieves the highest risk-adjusted return. For example, Blackstone Group and Carlyle Group are often on different sides of transactions.[35] The universe of bidders for any given company includes other financial investors and strategic bidders. In this perspective, the market for corporate control is highly competitive and is likely to become even more so in light of the high returns that buyout groups generate, thus attracting new entrants. Low barriers to entry are another important attribute of competitive markets and an indication that the ground is not fertile for collusion or other conspiracies to stifle competition. For example, a new group of direct private-equity competitors, who know the buyout business, are investors of LBO funds. Ontario Teachers' Pension Plan, a frequent limited partner in buyout funds with $85 billion in assets, recently entered the business of investing directly in LBO deals.[36]

Even if club deals were somehow able to restrict competition, the target company stockholders would not be obliged to accept the bids. Finally, the transaction costs of putting together, executing, and maintaining club deals limit their frequency. The ownership-centered model of private equity emphasizes accountability and clarity of responsibility. Having a number of firms own a company when it is taken private blurs this clarity and weakens incentives to perform.[37] Multiple owners with different

34. Economists have drawn attention to "repeated games," such as multiple auctions, in which the same companies participate and that may present opportunities for rivals to become too friendly. Then, instead of competing head to head, they may coordinate who wins deals to prevent price wars. Federal auctions for wireless spectrum and outer-continental-shelf oil-lease tracts are cases in which the repeated nature of auctions allegedly has facilitated the signaling of pricing strategies that has lessened competition.

35. For example, in 2006, when Kinder Morgan Inc.'s management started to consider a buyout involving Carlyle, the company's board hired Blackstone's advisory arm to evaluate the bid (Berman and Sender 2006).

36. Ontario Teachers' Pension Plan, Canada's third-largest pension fund, has been a big investor with KKR, but recently found itself bidding against the buyout group for the Canadian telecom operator BCE.

37. In the "risk factor" section of its IPO filing, the Blackstone Group warns of downsides of "club deals":

perspectives on a company's management composition, strategy, and exit opportunities can create the same internal control problems that handicap public companies.

In sum, the allegation that club deals stifle competition has no merit. Economics and experience point to the opposite conclusion: club deals perform an important function by diversifying the risk of buyout-company investments and enable larger targets to be acquired. Hence, consortium bidding offers real efficiency-enhancing benefits, which explains why the practice has a long and legitimate history and why it can be expected to continue in the future.

Allegation 3: Buyout Groups Destroy Jobs and Create Unemployment

> The history of private-equity takeovers has been slashing, cutting a lot of jobs and making a lot of money for a handful of executives.
>
> —Buzz Hargrove, president of Canadian Auto Workers Union, qtd. in John Reed's "Cerberus Faces Obstacles"[38]

The simplistic notion of what LBO groups do is indeed dark: they enrich themselves and investors by buying public companies, loading them with debt, slashing employment, stripping the assets, and, soon afterward, flipping the company. Colorful and useful in stoking populist resentment, this perspective falls short of reality. The transformation of ownership and governance that occurs when public companies are taken private creates powerful incentives for the management team and the private-equity group to improve business and create value—generally more so than in a public corporation. A "strip and flip" strategy is inconsistent with the new owners' longer-term perspective, which goes beyond an IPO because buyout groups generally retain significant stakes after a company is taken public again.

Can a buyout lead to job loss? Certainly, if eliminating business lines and employment is necessary to enable a company to become economically stronger. For a growing number of mature industries that face global competition, the tremendous challenge is how to restructure efficiently and rationalize excess capacity. Organizational scholar Michael Jensen (1993) observes that conflict between shareholders and management exacerbates this challenge. Although reduction of overcapacity serves the shareholders' best interest, it does not always serve management's interest if it requires making unpleasant decisions and cutting back a business empire.

"Consortium transactions generally entail a reduced level of control by Blackstone over the investment because governance rights must be shared with the other private equity investors. Accordingly, we may not be able to control decisions relating to the investment, including decisions relating to the mgmt and operation of the co and timing and nature of any exit" (2007, 25, abbreviations in the original).

38. Also see the post by John Adler, director of private equity for capital stewardship, Service Employees International Union: "The larger story of the economy right now is that a small group of private equity and hedge fund 'masters of the universe' are growing incredibly wealthy, in part because they play by a different set of rules than the vast majority of economic actors, while most Americans' wages are stagnant and tens of millions can't afford health insurance" ("Big Union" 2007).

Wilbur Ross, CEO of W. L. Ross & Co. and a serial consolidator of mature industries such as steel, coal, and textiles, said of automobile executives: "It's almost as though the managements were saying, 'I'm going to retire in five to 10 years. I'll have labor peace, and then it will be someone else's problem" (qtd. in Lippert 2007).

As active investors directly resolve the conflict between shareholders and managers and bring accountability to play where little existed previously, they serve as a key ingredient in solving the overcapacity challenge in mature industries. The U.S. automobile industry and its suppliers exemplify a shrinking sector in which capacity significantly exceeds demand. U.S. car companies such as Ford and Chrysler have been losing money for many years. Seven major suppliers declared bankruptcy in the past two years. It is little wonder that buyout and hedge-fund groups are busy acquiring bankrupt and poorly performing companies and restructuring the industrial landscape. It is also not surprising that these efforts are clashing with the objectives of unions that seek to maintain workers jobs and benefits. Basil "Buzz" Hargrove, president of the Canadian Auto Workers union, has a stark vision: "We see private equity as cutting and slashing so they can sell the company and make a lot of money at the expense of people's jobs and livelihoods" (qtd. in Lippert 2007).

In late April 2007, the Service Employees International Union released a report criticizing private equity.[39] It accuses buyout investors of Warner Music Group, including Thomas H. Lee Partners, of hollowing "out a once-proud music company, harming its image in the music industry, and potentially reducing its long-term value." The consortium of buyout groups that bought Warner Music Group from Time Warner in 2004 is also accused of cutting one thousand employees, about one-fifth of its workforce. Scott Sperling, copresident of Thomas H. Lee Partners, has said that Warner Music was "burdened with an unsustainable business model" and had too many layers of decision makers (qtd. in Wong 2007).

Today, in addition to buying out mature companies, a growing number of growth-oriented buyouts aim at creating value by expanding a company's business. This trend is being encouraged by rapid technological change and globalization. The greater openness of world markets spurs economies of scale and scope and enables technology to be shared and applied faster. Larger buyout firms such as KKR, Carlyle Group, Blackstone Group, and others operate around the globe and thus are especially well placed to see opportunities and to combine and leverage businesses. As a result, they have grown significantly not only as asset managers, but also as employers. For example, the total number of employees at the portfolio companies owned by Blackstone Group and KKR are 400,000 and 565,000 respectively.

39. The union also launched a new Web site, http://www.behindthebuyouts.org, which is to "become a clearinghouse for information on the buyout industry."

What do researchers conclude about private-equity's impact on employment? Evidence generally indicates that buyouts are net job creators:

- A study by Nottingham University's Centre for Management Buy-out Research that looked at four hundred management buyouts in the United Kingdom between 1999 and 2004 shows that although employment typically fell 2.3 percent in the year after a buyout, it then rose and was 26 percent greater after five years. Moreover, the center finds that companies are on average 70 percent more productive after their acquisition by a private-equity firm (Wright, Burrows et al. 2007).[40]
- An A. T. Kearney study shows employment at private-equity-backed companies in Europe between 2000 and 2004 grew on average 5.4 percent, compared to 2.9 percent at "traditionally" financed companies. In the United States, private-equity-backed companies grew on average 2.3 percent, compared to –0.7 percent at "traditionally" financed companies. In general, the study concludes, "Private equity investors often create a significant number of new jobs—one million over the past four years in Europe and 600,000 in the United States. And private equity–financed firms, on average, generate employment at a much faster pace than comparable, traditionally-financed firms" (2007, 1).
- A Dealogic study for the *Financial Times* examines the thirty largest private-equity deals that occurred during 2003 and 2004 and finds that the companies added a net 36,000 jobs, or 25 percent, to the 141,000 persons they employed when they were bought (Taylor and Bryant 2007).

In sum, if we value economic growth and higher living standards, we should focus on making sure resources—human, physical, and financial capital—are put to the best use. As an extension of the market and a proven mechanism for allocating resources efficiently, private-equity firms foster such efficient allocations. If employment is the focus, it should be examined over time to take into account the job creation that occurs when businesses are made more productive and hence become more capable of expanding. The analysis to date shows that by this measure, private-equity firms are net job creators. Steven Kaplan, a professor of finance at the University of Chicago and a long-time scholar of private-equity firms, notes that "private equity is both a job creator and job destroyer. Part of what private equity does is make companies more efficient—which may mean cutting jobs. But you can create value by growing faster or doing things better, which can increase jobs" (qtd. in Wong 2007).

40. According to the European Venture Capital Association, the number of employees at British companies backed by private-equity firms has risen about 9 percent a year in each of the past five years, compared with an average increase of 1 percent at publicly traded companies that are part of the FTSE 100 stock index (Werdigier 2007).

Allegation 4: Profits Should Be Taxed as Ordinary Income, Not as a Capital Gain

> I think Congress is now looking for revenue because they've got some holes to fill and private equity—because it's gotten so much publicity—is an attractive source of potential revenue.
>
> —David Rubenstein, cofounder, Carlyle Group, qtd. in "Taxing Times"

It has long been standard practice to define the profits or carried interest that general partners earn as capital gains and to tax them at the (current) 15 percent rate rather than at the (current) 35 percent rate on ordinary income in the highest bracket. In the past year, a debate in Congress and the media has raised the question of whether carried interest should be defined as ordinary income instead of as a capital gain. This question overlooks perhaps the most fundamental question: Why are there two rates that penalize some income-earning activities and reward others? The very debate and the amount of resources that interest groups consume in trying to preserve or to change the system demonstrate how departures from tax-system simplicity and neutrality open the door to resource waste on a large scale.

Like the employment allegation, the idea that private-equity firms are unfairly receiving preferential tax rates appeals to ideological arguments about income inequality. In addition, the potential to increase tax rates has the added political attraction given that it provides a means for Congress to collect more tax revenue that it can transfer to politically more "deserving" groups (for example, important voting blocks, such as the middle class). Private-equity partners, by almost any media account, represent "fat cats" and therefore excellent targets. Penalizing them with higher tax rates, despite any broader and damaging economic effects, might score important political points and be taken as a worthwhile policy endeavor.

An indication of the issue's significance can be seen in the ease with which those who write about private equity for a living quickly jumped to support the idea of raising taxes on carried interest. Andrew Ross Sorkin of the *New York Times Dealbook* has written: "Let's be honest: it is a charade that private equity firms have claimed their 20 percent performance fees at the lower capital gains rate. To qualify, they invest a nominal amount of their own money to demonstrate that they have put something at risk, but it's a ruse. They are paying capital gains rates for doing their job, which should be taxed at the regular income rate" (2007).

Yet not far below the surface is the stronger, more ideological driver of Sorkin's and others' concern: "You would think that all the buyout kings who wear American flags on their suit lapels would be proud to pay a big tax bill" (Sorkin 2007). For Sorkin, the issue has less to do with established partnership tax principles than with unequal distribution of wealth. Although private-equity partners have earned their wealth legitimately within the rules of the game and have created substantial value for the broader economy and investors, the claim is that they should share more of their returns because they can. Sorkin's view is shared by many financial writers and commentators in publications such as Thomson's *PE Week Wire,* the *Wall Street Journal*, the *New York Times*, and the *Financial Times.* Whether the writers understand the arcane details of tax policy and economics, for many of them the issue comes down to an "embarrassment of riches," where common-sense public relations demand the willing payment of more taxes to the government.

The stakes are indeed high and go beyond a public-relations stance animated by populism. Carried interest is the chief driver of private-equity business—the incentive that drives general partners to create value for investors and at the same time to build better businesses. It is an investment return on the fund's capital that buyout firms put to work, some of which consists of a general partners' own capital. General partners participate in the carry only after original funds plus profits are returned to limited partners. Private-equity groups realize this return when they exit their investments—taking a portfolio company public or selling it to another firm—for more than they paid for it. Because these profits have been classified as long-term capital gains, they are taxed at the (current) capital-gains rate of 15 percent. Management fees, the other form of private-equity compensation, are taxed at the (current) ordinary-income rate of 35 percent. These fees compensate general partners for administrative and operating expenses and tend to range from 0.75 percent to 3 percent of capital under management.

Senator Charles Grassley (R-Ia.), a senior member of the Senate Finance Committee, has suggested that all carried interest be taxed at the 35 percent ordinary-income rate. A move from 15 percent to 35 percent would significantly lower the after-tax income of general partners and therefore would have an adverse affect on the private-equity business model. A similar proposal is afoot in the United Kingdom, where the media and the trade unions have targeted the alleged "generous tax treatment" of private equity. In the United Kingdom, buyout groups face a 40 percent capital-gains rate, but if investments are held for two years, the so-called taper relief rules reduce this rate to 10 percent (Arnold 2007b). Unions have vehemently maintained that this relief undermines the principle of progressive taxation. More important, the wedge between the two rates in the United Kingdom and the United States distorts resource allocation and fuels rent seeking as interest groups plow money into changing or preserving the rules of the game rather than into creating value.

What is surprising about the allegation that carried interest is ordinary income—a point that has not received much attention in the media—is that it runs counter to "the well-established principle of partnership taxation that has been enshrined in the Internal Revenue Code of decades," as tax attorneys Stefan Boshkov and Jennifer Kurtis have written. Hence, "tax treatment of fund managers is not a 'loophole' that is being exploited by clever private equity fund managers" (2007, 3). The tradition of taxing carried interest as capital gains goes back to the relationship between these profits and the long-term investment success of private-equity funds and their limited-partner investors. To qualify for capital-gains treatment, an investor must put some funds at risk, as both limited partners and general partners do normally.

Proponents of ordinary income tax treatment have argued that because the investment funds at risk are mostly those of the limited partners, the general partners are merely service providers, and therefore the carried interest is strictly compensation for services provided, and it should be classified as ordinary income and taxed at a higher rate. Private-equity general partners are managers of capital, and like the partners of investment banks such as Goldman Sachs and Morgan Stanley, they should pay the ordinary income tax rate, say critics of the present system. This view reflects one of the bigger blind spots in the general critique of the private-equity model. Critical to this model's success is the general partners' *active* (not passive) full-time participation wherein they devote their time, use their capital, and transform the ownership and governance of public companies. This process differs fundamentally from what service providers, such as passive money managers, do. Private-equity partners are indeed active participants and catalysts in the capital-formation business.

Taxing general-partner profits at the 35 percent rate is also justified, some critics claim, because buyouts are eroding the corporate tax base as companies go private. Yet, according to the U.S. Congressional Budget Office, revenue from corporate income taxes increased from 1.2 percent of gross domestic product in 2003 to 2.7 percent in fiscal 2006, the highest level since 1978 (Raghavan 2007). The great danger of the grab for more tax dollars is its potential to harm buyout businesses' ability to restructure companies, improve corporate governance, and generate returns for investors. Such a change of policy might also establish a damaging precedent by suggesting that tax policy is best made not according to sound economic and legal principles, but according to appeals for a more evenly distributed income.

Defending private-equity's present tax rate does not imply that the present policy of taxing capital gains and ordinary income at different rates is economically sensible. Few economic principles of taxation are more important than simplicity and neutrality—the tax system should not treat similar types of income differently. Two fundamental reasons support this argument, but they have received little if any attention in the debate:

- Preferential treatment of one form of income over another creates a distortion in the market's system of allocating capital. As economist Alan Blinder said in reference to tax preference for capital gains: it "undermines capitalism—a system in which capitalists, not the state, are suppose to make the investment decisions" (2007).
- Wedges in the tax system, as this debate makes clear, attract significant resources into unproductive, rent-seeking activities as interest groups hire lawyers and lobbyists to persuade politicians to change the rules or to defend the existing rules. These resources can be put to more productive use.

The economy works best when a few simple rules apply equally to all economic actors. Removing distortions and cutting back opportunities to channel resources into unproductive pursuits serve the interests of everyone except the rent seekers. Private equity would gain significant credibility and ultimately be economically better off if its investors took a strong position in support of tax simplicity and neutrality—a position that would move ordinary income tax rates into line with capital gains tax rates.[41]

Conclusion

> Here's what private equity firms have figured out how to do: Attract and keep the world's best managers, focus them extraordinarily well, provide strong incentives, free them from distractions, give them all the help they can use and let them do what they can do. No wonder these companies tend to be outstanding performers.
>
> —Geoffrey Colvin and Ram Charan, "Private Equity, Private Lives"

Edmund Phelps (2006) has observed that F. A. Hayek described how capitalist economic systems "possess the greatest dynamism" and hence create the most wealth. This creative process relies on credible, predictable rules of the game, which enable economic institutions such as public corporations and partnerships to raise tremendous amounts of capital from individuals and institutions and invest it with a reasonable degree of certainty.

Within this dynamic and highly competitive process, private-equity firms have evolved and grown because of their comparative advantage in solving the information and incentive problems inherent in the public-company model. Private-equity buyout groups have created tremendous wealth for their investors and themselves by transforming the ownership and governance structures of public companies in going-private transactions. Competition and powerful ownership incentives have been key drivers of this process, which has increased accountability, safeguarded against fraud and accounting abuse, and enabled buyout groups to create significant value by restructuring firms and industries globally.

Private equity's success has caused buyout groups to grow larger and wealthier—but also to become easy targets for critical media and politicians. Ignorance about what these groups actually do, the self-interest of those threatened by the competition these groups engender (for example, incompetent corporate managers and poor money managers), and a bias against capitalism in general have put buyout groups

41. Although the capital-gains tax is getting substantial attention, of more concern is the U.S. corporate tax rate, say tax experts. Jason Furman of the Brookings Institution states that the United States has the second-highest corporate tax rate among the thirty countries of the Organization for Economic Cooperation and Development (Raghavan 2007).

under suspicion and continual attack. This backlash runs the risk of provoking legal and regulatory changes that raise the cost of buyouts and discourage the economically beneficial activities they undertake.

The common allegations against these groups are groundless. The private-equity model is a vastly different way of organizing business, with vastly different and efficiency-enhancing implications for a firm's governance, control, and productivity. Understanding these differences and the mechanics of the buyout process should help to close the knowledge gap and to ensure that the broader marketplace remains dynamic and productive.

Private-equity firms and active investors more generally will continue to evolve and to flourish in the future if the rules of the game remain clear, predictable, and neutral. Government regulations such as the Sarbanes-Oxley Act, the Investment Company Act of 1940, and exchange-listing rules, which restrict the large shareholders' ability to monitor their investments closely, inhibit public companies from adopting the ownership and board changes that drive the private-equity process of wealth creation.

The present turmoil in global credit markets, which is drying up liquidity and creating challenges for buyout groups in lining up debt, provides a good test of private equity's staying power. Critics of private equity have been quick to suggest that the buyout boom has gone bust. Legendary bond investor Bill Gross at PIMCO has put the market on notice: "The tide appears to be going out for levered equity financiers and in for the passive owl money managers of the debt market. . . . No longer will double-digit LBO returns be supported by cheap financing and shameless covenants" (2007).

If pundits and critics are right in their allegations, the private-equity businesses will experience a severe contraction, if not mortal wound. If buyouts are more than a financial game fueled by cheap debt, however, the present turmoil will no more signal an end to private-equity buyouts than it signals an end to mergers and acquisitions by strategic buyers and sellers. Private equity's dynamism suggests the industry will adapt to market conditions and search out new opportunities—especially where voluntary transactions between shareholders and buyout groups can create gains for both sides. The larger global-asset managers with distressed debt and equity funds are well positioned to capitalize on opportunities across the capital structure in good times and bad. Private equity's ownership and governance advantages and its broader asset management provide a solid foundation for these firms to weather today's economic turbulence and to create new and better businesses tomorrow.

References

Arnold, Martin. 2007a. Buy-out Chiefs in Market for Personal Loans. *Financial Times,* June 16.

———. 2007b. SVG Chairman Breaks Tax Taboo. *Financial Times,* June 4.

A. T. Kearny. 2007. Creating New Jobs and Value with Private Equity. Available at: http://www.atkearney.com/main.taf?p=5,3,1,158.

Bailey, Elizabeth M. 2007. Are Private Equity Consortia Anticompetitive? The Economics of Club Bidding. *The Antitrust Source* (April): 1–8.

Bary, Andrew. 2007. Unclear LBO Path for Clear Channel. *Barron's,* January 22. Available at: http://online.barrons.com/public/article/SB116925715940882299-d0weh5ggJNU24jqxsnk5alg_rpg_20070219.html?mod=mktw.

Beales, Richard. 2007. Case Study: Domino's. *Financial Times,* July 25.

Berkshire Hathaway Inc. 1999. *An Owner's Manual.* A message from Warren E. Buffett, chairman and CEO, January. Omaha, Neb.: Berkshire Hathaway Inc. Available at: http://www.berkshirehathaway.com/owners.html.

Berman, Dennis. 2007a. Buyout Shops: Sharks Serving Vital Function. *Wall Street Journal,* March 13.

———. 2007b. Unusual Buyout Offers a Piece to Shareholders. *Wall Street Journal,* April 27.

Berman, Dennis, and Sarah McBride. 2007. Clear Channel Showdown Signals Investors' Wariness of Privatizations. *Wall Street Journal,* January 27.

Berman, Dennis, and Henry Sender. 2006. Probe Brings "Club Deals" to Fore. *Wall Street Journal,* October 11.

Big Union Takes Skeptical Look at Private Equity. 2007. *New York Times Dealbook,* April 24.

Biltz, Roger. 2007. Dealmaker Puts Blackstone in the Penthouse. *Financial Times,* July 11. Available at: http://search.ft.com/ftArticle?queryText=Dealmaker+Puts+Blackstone+in+the+Penthouse%2C&y=9&aje=true&x=9&id=070712000668&ct=0.

Blackstone Group L.P. 2007. *Preliminary Prospectus.* SEC Form S-1, March 22. New York: Blackstone Group. Available at: http://www.sec.gov/Archives/edgar/data/1393818/000104746907002068/a2176832zs-1.htm.

Blinder, Alan. 2007. The Under-Taxed Kings of Private Equity. *New York Times,* July 29. Available at: http://www.nytimes.com/2007/07/29/business/yourmoney/29view.html.

Boshkov, Stefan, and Jennifer Kurtis. 2007. Carried Interests: Payment for Services or a Return on Investment. *Nixon Peabody* (April 18): 1–3. Available at: http://www.nixonpeabody.com/linked_media/publications/PvtEqLBO_eIss2_Spring07.pdf.

Breakingviews. 2006. On Going Private: Investors Beware. *Wall Street Journal,* November 18.

———. 2007. Zell Welds a Mighty Gavel. *Wall Street Journal,* January 26.

Cao, Jerry X. 2008. An Empirical Study of LBOs and Takeover Premium. Social Science Research Network, February 18. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1086775.

Cao, Jerry X., and Josh Lerner. 2006. *The Performance of Reverse Leverage Buyouts.* Working paper, October 15. Cambridge, Mass.: Harvard Business School. Available at: http://ssrn.com/abstract=937801.

Caplan, Bryan. 2007. *The Myth of the Rational Voter: Why Democracies Choose Bad Policies.* Princeton, N.J.: Princeton University Press.

Carey, David. 2007. Deliver and You Get Paid. *Deal.com,* June 5. Available at: http://www.thedeal.com/corporatedealmaker/2007/08/deliver_and_you_get_paid.php.

Colvin, Geoffrey, and Ram Charan. 2006. Private Equity, Private Lives. *Fortune,* November 27. Available at: http://money.cnn.com/magazines/fortune/fortune_archive/2006/11/27/8394344/index.htm.

Dealogic. 2007. Information supplied directly to author.

Eden, Scott. 2007. The Original Buyout King. *Dealmaker* (March–April): 92.

Flaherty, Michael, and Lilla Zuill. 2007. Blackstone Raises $4.1 bln; Largest US IPO in 5 Yrs. Reuters, June 22. Available at: http://www.reuters.com/article/companyNewsAndPR/idUSN2142941920070622.

Gertner, Robert, and Steve Kaplan. 1996. *The Value-Maximizing Board.* Working paper. Chicago: University of Chicago, Graduate School of Business, December.

Gilson, Ronald, and Reiner M. Kraakman. 2005. Takeovers in the Boardroom: Burke versus Schumpeter. Social Science Research Network, May. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=732783.

Gross, Bill. 2007. Investment Outlook: Enough Is Enough. PIMCO, August. Available at: http://www.pimco.com/LeftNav/Featured+Market+Commentary/IO/2007/IO+August+2007.htm.

Guerrera, Francesco, and James Politi. 2007a. Legrand Poses Dilemma of When to Flip Stake. *Financial Times,* May 14.

———. 2007b. Private Dose of Tough Love. *Financial Times,* May 15. Available at: http://search.ft.com/ftArticle?queryText=A+Private+Dose+of+Tough+Love&aje=false&id=070514009609&ct=0.

———. 2007c. Private Equity Firms Aid Conglomerates. *Financial Times,* January 10.

Guerrera, Francesco, James Politi, and Ben White. 2007. Pig Flies High as Blackstone Barons Unveil Riches. *Financial Times,* June 12.

Haarmeyer, David. 2006. Corporate Governance Rx: Active Investors. *Directors Monthly* (National Association of Corporate Directors) (June): 8–10.

———. 2007. The Revolution in Active Investing: Creating Wealth and Better Governance. *Journal of Applied Corporate Finance* 19, no. 1 (winter): 26–41.

Holthausen, Robert, and David Larcker. 1997. Performance, Leverage, and Ownership Structure in Reverse LBOs. *Journal of Applied Corporate Finance* (spring): 293–332.

Hughes, Chris. 2007. Why It Can Pay to Think the Unthinkable. *Financial Times,* May 30. Available at: http://search.ft.com/ftArticle?queryText=Why+It+Can+Pay+to+Think+the+Unthinkable&y=3&aje=false&x=7&id=070529008140&ct=0.

Jensen, Michael C. 1986. Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers. *American Economic Review* 76, no. 2 (May): 323–29.

———. 1993. The Modern Industrial Revolution, Exit, and Failure of Internal Control Systems. *Journal of Finance* 48, no. 3 (July): 831–80.

Kahan, Marcel, and Edward Rock. 2007. Hedge Funds in Corporate Governance and Corporate Control. *University of Pennsylvania Law Review* 155, no. 5 (May): 1021–93.

Kaplan, Steve, and Antoinette Schoar. 2005. Private Equity Performance: Returns, Persistence, and Capital Flows. *Journal of Finance* 60, no. 4 (August): 1791–1823.

Kinsley, Michael. 2006. A Capitalist Swindle. *Washington Post,* November 21.

Klein, April, and Emanuel Zur. 2006. *Hedge Fund Activism*. Working Paper no. 140/2006. Brussels: European Corporate Governance Institute, October.

Klein, M., Marc Zenner, and A. Shivdasani. 2006. *The Private Equity Revolution: Are You Ready?* New York: Citigroup Corporate and Investment Banking, November 6.

Kranhold, Kathryn, and Joann S. Lublin. 2006. $100 Million Helps Lure Away General Electric Veteran. *Wall Street Journal,* August 24.

Lerner, Josh. 2007. Government's Misguided Probe of Private Equity. *WorkingKnowledge,* (Harvard Business School), March 14. Available at: http://hbswk.hbs.edu/item/5655.html.

Lippert, John. 2007. Carving Up Detroit. *Bloomberg Markets* (June): 55.

Macey, Jonathan. 2007. What Sarbox Wrought. *Wall Street Journal,* April 7. Available at: http://online.wsj.com/article/SB117591225568262911-search.html?KEYWORDS=jonathan+macey&COLLECTION=wsjie/6month.

McCafferty, Joseph. 2007. The Buyout Binge. *CFO Magazine* (April 1). Available at: http://www.cfo.com/article.cfm/8909971/c_8910395?f=singlepage.

Meerkatt, Heino, and John Rose. 2006. *What Public Company's Can Learn from Private Equity*. Boston: Boston Consulting Group.

Moon, John J. 2006. Public vs Private Equity. *Journal of Applied Corporate Finance* (summer): 76–82.

Morgan Stanley Roundtable on Private Equity and Its Import for Public Companies. 2006. *Journal of Applied Corporate Finance* 18, no. 3 (summer): 8–37.

Muller, Jerry Z. 2002. *The Mind and the Market: Capitalism in Western Thought*. New York: First Anchor Books.

Paulden, Pierre. 2006. Alpha Maelstorm. *Institutional Investor* (June).

Pettit, Justin. 2007. Too Much Money. *Strategy and Business* (spring). Available at: http://www.strategy-business.com/press/article/07112?pg=0.

Phelps, Edmund. 2006. Dynamic Capitalism. *Wall Street Journal,* October 10. Available at: http://www.opinionjournal.com/editorial/feature.html?id=110009068.

Politi, James. 2007. TXU Defends Benefits of $45bn Buyout. *Financial Times,* February 26. Available at: http://search.ft.com/ftArticle?queryText=+%E2%80%9CTXU+Defends+Benefits+of+%2445bn+Buyout&aje=false&id=070226010487&ct=0.

Politi, James, and Deborah Brewster. 2007. KKR and TPG Face TXU Investor Fight. *Financial Times,* July 25.

Private Equity Intelligence (PEI). 2007a. *Private Equity Spotlight* (London) 2, no. 10 (January): 1.

———. 2007b. *Private Equity Spotlight* (London) 3, no. 5 (May): 1–15.

———. 2007c. *Private Equity Spotlight* (London) 3, no. 7 (July): 1–14.

Private Equity Players Hit the Big Time: An "Out-of-Body Experience." 2007. *Knowledge@Wharton*. Available at: http://knowledge.wharton.upenn.edu.

Prowse, Stephen. 1998. The Economics of the Private Equity Market. *Federal Reserve Bank of Dallas Economic Review* (third quarter): 21–34.

Raghavan, Anita. 2007. Debt and the Corporate Tax Base. *Wall Street Journal,* June 16–17.

Reed, John. 2007. Cerberus Faces Obstacles in Fixing Chrysler. *Financial Times,* May 14.

Rosenbush, Steve. 2007a. How Texas Pacific Cleaned Up at J. Crew. *Business Week,* February 6. Available at: http://www.businessweek.com/bwdaily/dnflash/content/feb2007/db20070206_483648.htm.

———. 2007b. Private Equity Slugfest. *Business Week,* February 13. Available at: http://www.businessweek.com/bwdaily/dnflash/content/feb2007/db20070212_956645.htm.

Schumpeter, Joseph. 1962. *Capitalism, Socialism, and Democracy*. New York: Harper Torchbooks.

Seligman, Dan. 2007. The Colorful Life of Capital's Champion. *Wall Street Journal,* April 5.

Sender, Henry. 2007. Inside the Minds of Kravis, Roberts. *Wall Street Journal,* January 3.

Service Employees International Union. 2007. *Behind the Buyouts: Inside the World of Private Equity*. Washington, D.C.: Service Employees International Union, April.

Smith, Peter. 2005. Blackstone Magic: How Two Men Rode the Private Equity Wave and Landed a Fortune. *Financial Times,* December 1.

Sorkin, Andrew Ross. 2007. Of Private Equity, Politics, and Income Taxes. *New York Times Dealbook,* March 11.

Stulz, Rene, Leonce L. Bargeron, Frederik Schlingemann, and Chad Zutter. 2007. *Why Do Private Acquirers Pay So Little Compared to Public Acquirers?* National Bureau of Economic Research (NBER) Working Paper. Cambridge, Mass.: NBER. Available at: http://www.nber.org/papers/w13061.

Taxing Times. 2007. *PrivateEquityOnline,* May 11, 1. Available at: http://www.privateequityonline.com.

Taylor, Andrew, and Chris Bryant. 2007. Buyout Firms Defy Job-Cutting Reputation. *Financial Times,* April 2.

Teitelbaum, Richard. 2007. The KKR Way. *Bloomberg Markets* (July): 38.

Thomson Financial and National Venture Capital Association. 2007. *Private Equity Performance Remains Steady in Q3 2006*. New York and Arlington, Va.: Thomson Financial and National Venture Capital Association, January 29.

Werdigier, Julia. 2007. In Europe, Private Equity Firms Strive to Buff Image. *New York Times,* March 5.

Wessel, David. 2002. Professor Summers Offers Economic Policy Precepts. *Wall Street Journal,* October 21. Available at: http://online.wsj.com/article/SB1034802542167161468.html?mod=economy_secondary_stories_hs.

Whitehouse, Kaja. 2007. The Activist Game: It's Not Just for Hedgies. *Wall Street Journal,* March 14.

Wong, Grace. 2007. Private Equity and the Job Cut Myth. *CNNMoney.com,* May 2. Available at: http://money.cnn.com/2007/05/02/markets/pe_jobs/index.htm.

Wright, Mike, Andrew Burrows, Rod Ball, and Louise Scholer. 2007. *Private Equity and Buy-outs: Jobs, Leverage, Longevity, and Sell-offs.* London: Centre for Management Buyout Research, Nottingham University Business School. Available at: http://www.nottingham.ac.uk/business/cmbor/PEarticle.pdf.

Wright, Mike, Michael Jensen, Douglas Cumming, and Don Siegel. 2007. *The Impact of Private Equity: Setting the Record Straight.* London: Centre for Management Buyout Research, Nottingham University Business School. Available at: http://www.nottingham.ac.uk/business/cmbor/impact.pdf.

Wruck, Karen Hopper. 1998. *Financial Policy, Internal Control, and Performance: Sealed Air Corporation's Leveraged Special Dividend.* Columbus: Fisher College of Business, Department of Finance, Ohio State University, May 7. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=5352.

Acknowledgment: The views expressed in this article are my own and do not necessarily represent those of PowerAdvocate.