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What do private equity firms say they do?☆

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ABSTRACT

We survey 79 private equity (PE) investors with combined assets under management of more than $750 billion about their practices in firm valuation, capital structure, governance, and value creation. Investors rely primarily on internal rates of return and multiples to evaluate investments. Their limited partners focus more on absolute performance as opposed to risk-adjusted returns. Capital structure choice is based equally on optimal trade-off and market timing considerations. PE investors anticipate adding value to portfolio companies, with a greater focus on increasing growth than on reducing costs. We also explore how the actions that PE managers say they take group into specific firm strategies and how those strategies are related to firm founder characteristics.

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1. Introduction

The private equity (PE, buyout) industry has grown markedly since the mid-1990 s, and academic research has increasingly focused on the effects of private equity.[1] What have been less explored are the specific analyses and actions taken by PE fund managers. This paper seeks to fill that gap. In a survey of 79 private equity firms managing more than $750 billion in capital, we provide

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[1] We classify private equity as buyout or growth equity investments in mature companies. Private equity as we define it in this paper is distinct from and does not include venture capital (VC) investments. Many papers in the literature study both venture capital and buyout investments, particularly those related to performance for limited partners. We decided to pursue PE firms instead of VC firms for several reasons. First, PE firms take different actions and invest in different companies than VC firms. Studying the asset classes together would have made the paper even longer and more unwieldy. In contrast, performance can be compared across asset classes, making it sensible to study VC and PE together. Second, PE firms are arguably subject to more controversy about what they do and whether they create value. And, finally, PE is a much larger asset class.

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granular information on PE managers' practices in determining capital structure, valuing transactions, sourcing deals, governance, and operational engineering. We also explore how the actions that private equity managers say they take group into specific firm strategies and how those strategies are related to firm founder characteristics.

Recent academic research has provided accumulating evidence that private equity investors have performed well relative to reasonable benchmarks. At the private equity fund level, Harris, Jenkinson and Kaplan (2014), Higson and Stucke (2012), Robinson and Sensoy (2013), and Ang, Chen, Goetzmann, and Phalippou (2013) all find that private equity funds have outperformed public equity markets net of fees since the mid-1980s. The outperformance versus the Standard & Poor's (S&P) 500 in Harris, Jenkinson, and Kaplan is on the order of 20% over the life of a fund and roughly 4% per year. Consistent with that net of fee performance, Axelson, Sorensen, and Strömberg (2013) find outperformance of over 8% per year gross of fees.

At the private equity portfolio company level, Davis, Haltiwanger, Handley, Jarmin, Lerner, and Miranda (2014) find significant increases in productivity in a large sample of US buyouts from the 1980s to early 2000s. Cohn and Towery (2013) find significant increases in operating performance in a large sample of US buyouts of private firms. Kaplan (1989) finds significant increases in public to private deals in the 1980s. Cohn, Mills, and Towery (2014) and Guo, Hotchkiss, and Song (2011) find modest increases in operating performance for public to private buyouts in the 1990s and early 2000s, although Guo, Hotchkiss, and Song find large increases in company values.

From Gompers and Lerner (1999), Metrick and Yasuda (2010), and Chung, Sensoy, Stern, and Weisbach (2012), we also know that the compensation of the partners at the private equity funds creates strong incentives to generate high returns, both directly and through the ability to raise subsequent funds. Strong performance for some funds has led to very high compensation for those investors.

The high-powered incentives combined with the largely positive empirical results are consistent with PE investors taking actions that are value increasing or maximizing. Kaplan and Strömberg (2009) classify three types of value-increasing actions: financial engineering, governance engineering, and operational engineering. These value-increasing actions are not necessarily mutually exclusive, but certain firms likely emphasize some of them more than others.

In financial engineering, PE investors provide strong equity incentives to the management teams of their portfolio companies. At the same time, leverage puts pressure on managers not to waste money. In governance engineering, PE investors control the boards of their portfolio companies and are more actively involved in governance than public company directors and public shareholders. In operational engineering, PE firms develop industry and operating expertise that they bring to bear to add value to their portfolio companies.

Despite the growth in private equity, only a few papers have studied the actions that private equity investors take. Early papers by Baker and Wruck (1989) and Baker (1992) explored value creation in individual cases. More recently, Acharya, Gottschalg, Hahn, and Kehoe (2013) study portfolio company performance and relate that performance to PE firm and partner characteristics. Much still remains unknown. No paper examines detailed levers of value creation across financial, governance, and operational engineering.

In this paper, we further explore what PE investors do by reporting the results of a survey of private equity investing practices. First, we identify and tabulate the key decisions that private equity investors make. The range of decisions is significantly more detailed than has been examined in the prior literature. Our survey is structured around examining decisions that support financial, governance, or operational engineering. Second, we attempt to categorize distinct strategies that private equity firms employ.

We survey 79 PE investors [with a total of more than $750 billion of private equity assets under management (AUM) as of the end of 2012]. We obtain complete answers from 64 of these firms (representing more than $600 billion of private equity AUM). The sample represents private equity firms across a spectrum of investment strategies, size, industry specialization, and geographic focus. We ask the PE investors questions about financial engineering—how they value companies and how they think about portfolio company capital structures and management incentives; governance engineering—how they think about governance and monitoring; and operational engineering—how they think about value creation, both before and after closing the transaction. We also ask questions about the organization of the private equity firms themselves.

Despite the prominent role that discounted cash flow valuation methods play in academic finance courses, few PE investors use discounted cash flow or net present value techniques to evaluate investments. Instead, they rely on internal rates of return (IRRs) and multiples of invested capital (MOICs). This contrasts with the results in Graham and Harvey (2001), that chief financial officers (CFOs) use net present values as often as internal rates of return. Furthermore, few PE investors explicitly use the capital asset price model (CAPM) to determine a cost of capital. Instead, PE investors target a 22% internal rate of return on their investments on average (with the vast majority of target rates of return between 20% and 25%), a return that appears to be above a CAPM-based rate. We offer several potential explanations for this seemingly ad hoc approach to investment analysis.

We also asked the PE investors how their limited partners (LPs) evaluate the performance of the private equity investors. Surprisingly, the PE investors believe that their LPs are most focused on absolute performance than on relative performance or alphas. This is also puzzling given that private equity investments are equity investments, some of which had been publicly traded prior to a leveraged buyout. Such investments carry significant equity risk, suggesting that equity-based benchmarks such as public market equivalents (PMEs) are appropriate.

Our results on capital structure are more consistent with academic theory and teaching. In choosing the capital structures for their portfolio companies, PE investors

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