The Journal of Alternative Investments

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JAI 2018, 21 (2) 10-15
doi: https://doi.org/10.3905/jai.2018.21.2.010
http://jai.iijournals.com/content/21/2/10

Institutional Investor Journals
1120 Avenue of the Americas, 6th floor,
New York, NY 10036, Phone: +1 212-224-3589

Private Equity: *Rethinking the Neoclassical Axioms of Capital Markets*

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By all measures, the continuous growth and expansion of private equity has been astounding. From a $30 billion allocation worldwide in 1992, the industry has grown more than 200-fold in less than a quarter century and is estimated to triple over the next 10 years. Once regarded as a small blip at the margin of alternative investments, private equity has now moved to the center stage of capital markets. With its long-term record of success and the unprecedented increase in allocation by institutional investors, the private equity (PE) model has earned an eminent standing. Has it perhaps done more than that? Is it challenging some of the most fundamental principles of corporate finance?

THE NEW FACE OF PRIVATE EQUITY

Whereas stock markets have been in existence for at least 400 years,[1] private equity is a recent phenomenon. The first venture capital firm, the American Research & Development Corporation (ARD), was founded in 1946. The first buyout firm, Warburg Pincus, was only formed in 1966, raising money from investors one deal at a time, to be followed by TA Associates in 1968 with an early focus on venture and growth capital. Thomas Lee Partners, founded in 1974, was among the earliest independent firms that focused on the acquisition of companies with leverage financing. Yet it was not until the early 2000s that private equity has started to enter into institutional asset allocation decisions. For example, a look at two leading public pensions reveals that CalPERS asset allocation for 2001 was 4.5% to *all* alternatives, and the Washington State Investment Board (WSIB) had no allocation to alternatives at all.[2] Within 15 years, 2014–2016, their allocations to private equity grew to about 10% and 16%, respectively. Some of the major university endowments lead the pack in terms of private equity and related allocation. Most notably, the Yale Endowment had in 2016 a 31% allocation to buyout and venture capital and an additional 21% to natural resources and real estate, versus only 4% to U.S. equity and an additional 15% to foreign equity.

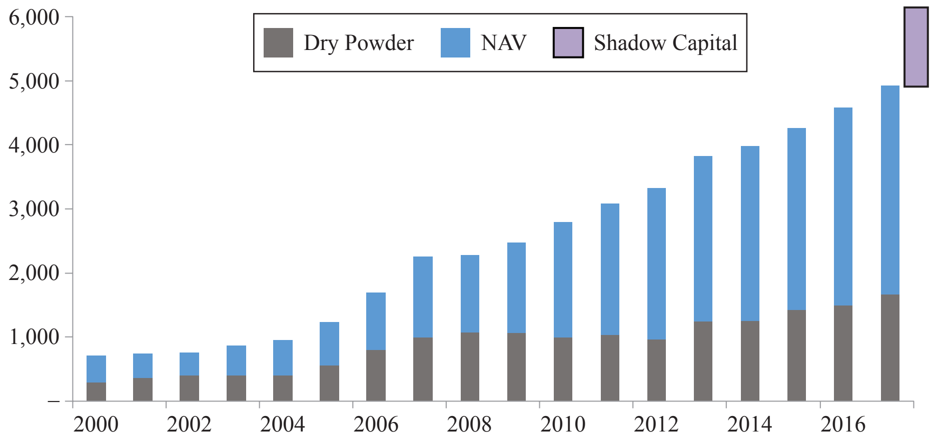
On its way to achieving its new status, private equity had to complete a major makeover. Private equity funds were first described in the United States as asset strippers and corporate raiders in the 80s and 90s and then labeled as "locusts" in Europe a decade later. However, the image of private

[1] The Amsterdam stock exchange was established in 1602 by the Dutch East India Company.

[2] Sources: CalPERS Annual Financial Reports and Washington State Investment Board Annual Reports.

EXHIBIT 1

Private Capital: 8× Increase over the Past 15 Years ($ billions)



Sources: Preqin 2018; shadow capital is estimated by Bain & Co. (2017) at 15%–20%.

equity improved after that, particularly through the global financial crisis beginning in 2008, when private equity became a notable nongovernmental force for growth and restructuring in the global economy. Whereas the origins of the industry lie in a modus operandi that focused on financial repackaging, in today's landscape, PE firms proclaim growth and operational value creation as their core competence. New investment strategies have become more sophisticated, such as platform investments or partnerships with strategic buyers through minority stake investments.

Venture capital has seen resurgence in activity and fundraising with eye-popping valuations and the proliferation of unicorns around the world. Private equity has also seen a massive expansion beyond its traditional domains of buyouts and growth capital to new types of assets. In particular, with the increasing limitations on loans by banks, private equity has strongly expanded into debt instruments. With the new regulatory environment following the post-2008 crisis, banks have been unable to extend much of the corporate and transactional credits they used to offer. This huge void is being replaced with nonbank credit in which PE firms play a key role. In addition to private credit funds, the industry has also massively expanded into infrastructure, real estate, energy, and other natural resources. The overall growth into these new sectors has reached such a magnitude that the industry has now commonly rebranded itself from "private equity" to "private capital" to better capture its broader domain.[3]

The secondary markets in PE interests have reached an unprecedented scale and maturity, with deals worth a record $58 billion completed in 2017. This has dispelled the main perceived barrier to investing in the asset class, namely, its illiquid nature. At the fund level, investment vehicles have become increasingly creative and diverse. Direct investing by in-house teams of institutional investors, the disintermediation and nontraditional structures, the so-called shadow capital, and in particular, co-investing mean that private equity is already of a far greater scale than the $5 trillion often referred to (see Exhibit 1).

Private equity has also become increasingly transparent, a blessed coming of age for the industry. This growth in transparency was initially aided by the granular disclosure required of public pension investors and, in recent years, through an explosion of data provided by financial information aggregators and prolific academic activity in the space. The Institutional Limited Partners Association (ILPA) released a disclosure guideline in 2016 on how fees and expenses should be reported, which is being fast adopted by the titan trendsetters of the industry.[4] There has been a drive by the U.S. SEC

[3] See https://www.preqin.com/docs/press/Fundraising-Update15.pdf and uncipc.org/.

[4] See https://ilpa.org/best-practices/reporting-template/get-template/.

toward "spreading sunshine in private equity," and we see far more regulation around the world—a trend that needs to be managed with caution and should be coordinated on a global level. With transparency and uniform disclosure, the industry has reached a state of maturity and acceptability like never before.

Innovation has taken many other forms, including stapled secondary/primary transactions, the use of capital call facilities (also known as subscription lines or draw-down facilities), distribution facilities, and experimentation with long-term and permanent capital.

THE SHRINKING STOCK MARKET AND THE FAILING GOVERNANCE OF PUBLIC COMPANIES

While private equity has prospered, many stock markets around the world have failed to take off, if not worse. In the United States, the number of listed firms is backsliding—experiencing a sharp decline of 50% over the last 20 years.[5] This is despite the fact that over those 20 years, the U.S. gross domestic product (GDP) grew at a healthy 3.6% compound annual growth rate (CAGR), adjusted for inflation. Also, during the period, total market capitalization of the listed companies more than doubled. The companies that are listed on exchanges are bigger, older, and in more concentrated sectors than two decades ago. The Herfindahl-Hirschman Index estimates industry concentration dropped to about 800 in 1996 and rose to roughly 1,200 in 2016. Hence, investors today have a limited ability to access directly the complete U.S. equity market and need to cast a much wider net than they did in the past. Other countries, such as Germany and Brazil, have also experienced a decline in public listings, although not quite to the extent as the United States (Wilson and Buenneke 2017).

The two contrasting trends of a shrinking stock market and the strong growth of private equity are not independent phenomena; both stem from the fact that private equity and publicly listed companies offer competing governance models. In fact, the major strength of private equity over publicly listed firms is in the form of corporate governance it offers. This echoes well with Jensen's (1989) observed weakness of the public corporation advocating that LBOs (leveraged buyouts), takeovers, and corporate breakups are organizational innovations that should be encouraged despite the criticisms and protests at that time.[6] Hence, it is instructive to review the governance of publicly listed companies with diffused ownership.

Corporate governance and shareholder control of public companies were known for years to be imperfect, giving rise to all sorts of unsound managerial incentives and a misalignment of interests between shareholders and management—the so-called agency problems. An array of control systems were instigated to improve corporate governance, to enforce control over management, and to lessen the agency problems at public companies. Some of the instruments in place are systemwide, whereas the others are internal controls, such as the following:

- a board of directors to oversee the company and to represent the interests of the shareholders;
- disclosure requirements and a slew of restrictions put forth by regulators (e.g., on related-party transactions, on insider trading, and in setting mandatory board obligations, to name a few);
- various conditions set at the time of an IPO by the stock exchange, the regulator, and the underwriters;
- financial accounting governed by IFRS or FASB;
- internal reporting and auditing;
- communication mechanisms, such as shareholder meetings, conference calls, and press releases;
- enforcement, including prosecution by the SEC or similar commissioners in other countries;
- transparency and a flow of information through data aggregators, websites and blogs, and ongoing media reporting;
- coverage by securities analysts.

Such an overarching envelope of control measures is very expensive to maintain. Substantial reporting and monitoring costs exist for both the corporation and the regulator. Some of these measures apply for both publicly listed and private companies; however, their severity on the former type is of a far higher magnitude. Yet, despite

[5] The number of publicly traded companies declined from 7,322 in 1996 to 3,700 in 2015 (Ulrich and Allen 2016). The decline in U.S. listings was noted by the media as early as 2011 and in academic research. See Doidge, Karolyi, and Stulz (2017) for references and for analyses of the decline in the propensity to list and increase in delisting through M&A, forced delisting for cause, and delisting voluntarily.

[6] The term private equity was only coined at a later time.

the elaborate regulatory mesh, its degree of effectiveness in listed companies is a continuing source of academic debate. Criticism of the governance of public companies centers on a number of factors, such as the following.

Board Structure

Listed companies are often dominated by ineffective boards that are too large in size. Some long-running firms, such as IBM, Ford, and Bank of America, have boards consisting of 14–16 members. In Europe, Deutsche Bank has a 20-member board. Technology companies, such as Microsoft, Alphabet (Google), and Amazon, have 11–12 members on their boards. In contrast, the board size of a typical PE company is 5 members, drastically reduced following an MBO or LBO.[7]

Perhaps because of the dispersed responsibility in large boards or because it is a part-time job, there is little expectation of non-executive directors to invest significant time into conducting their own analyses between board meetings. Contrary to private equity, board members of listed companies with diffused ownership do not have staff members or other resources to investigate beyond the basic material provided in board packets. These factors lead their style of engagement to be responsive rather than proactive governance. For example, there are generally no attempts to challenge management with independently produced alternative plans. Instead, there is more concern with legalities, a focus on oversight matters, such as disclosure or trading rules, to ensure no regulatory violations, emphasizing the functions of policeman and auditors. This concern is also reflected in the emphasis given to subcommittees with narrow mandates, such as environmental matters, health/safety, audit, and compensation. It is fair to say that boards of large listed corporations spend the bulk of their time on processes rather than on substance.

Not surprisingly, the majority of the academic research finds a negative impact of board size on firm performance and Tobin's Q (e.g., Jensen 1993; Yermack 1996). In contrast, the influential Sir David Walker Report (Walker 2007) described governance by private equity as where: "Lines of communications are short and direct, with effectively no layers to insulate or dilute conductivity between the general partner and the portfolio company executive team" (p. 23).

[7] See Cornelli and Karakas (2008).

Shareholder Engagement

Shareholders typically have no real say in the way a public company is run. Attendance at annual general meetings is minimal, with rarely any alternative to the motions advanced by management. This is particularly problematic when it comes to the selection of the board of directors. In practice, it is management that most often chooses the board members.[8]

Management Incentives

The literature has overall failed to agree that there is a linkage between executive pay and corporate performance.[9] Furthermore, management is not expected to invest its own funds. Performance-based compensation in the form of stock option plans is granted to management and other key employees as part of the overall remuneration package, which greatly differs from buying shares with one's own money (i.e., no genuinely painful "skin in the game"). Consistent with the prospect theory, the degree of effort that results and the alignment of interests with investors are significantly weaker than in cases of an outright equity investment by management.

Myopia

Investment horizons of equity market investors vary greatly; nobody expects shareholders in listed companies to be loyal because the governance model of diffused ownership is structured such that shareholders are detached. They can get in and out within seconds,

[8] Shivdasani and Yermack (1999) found evidence in support of CEOs effectively handpicking nominees and that the market's reaction to announcements of independent director appointments is significantly lower when the CEO is involved in the selection process. O'Neal and Thomas (1995) interviewed directors and reported that the CEO and the chairman are influential in director selection and that personal networks of directors play an important role in identifying suitable candidates. Hwang and Kim (2009) examined directors' social ties to CEOs and found that boards that have social ties with their CEO tend to reward the CEO a higher compensation package and are less likely to remove the CEO in the case of poor performance.

[9] Some recent studies document a strong negative association between executive compensation and future returns, especially for firms with weak corporate governance (e.g., Malmendier and Tate 2009; Cooper, Gulen, and Rau 2016).

or even take a short position.[10] Because private equity is less liquid, PE ownership is structured around a controlling sponsor who holds the assets for several years, which better incentivizes long-term value creation.

Lazy Balance Sheet

Companies may sit on piles of cash, rather than following the PE tenet that money belongs to the investors with a priority to distribute it back to them. It is estimated that in recent years U.S. companies have accumulated cash of about $2.6 trillion on their balance sheets—over three times what it was in 2000—and that cash and equivalents currently average $3 billion for the S&P 500 companies.[11] Is that a good recipe for "sweating the corporate assets"? In contrast, the PE model is centered on an outright sale of the portfolio companies, followed by an immediate distribution of the sale proceeds to the financial sponsors. PE distributions have reached such a magnitude that they have far exceeded the amount of capital calls in each of the last seven years.

Roadblocking Takeovers

Public companies resist takeovers as if it was their nemesis—setting up antitakeover mechanisms, such as poison pills, staggered boards, and so on. It is hard to grasp why it is in the interest of shareholders to block takeover bids, but it is very easy to see why this serves well the interests of management in protecting their jobs and pay.

Managed by Analysts

Possibly worst of all, operational decisions in public companies are highly influenced by the expectations of stock analysts, leading to such situations as the deferral of needed investments to gain short-term accounting cosmetics and cases where earnings management overrides business decisions.[12]

The unavoidable conclusion is that adding on regulation to enforce governance not only is ineffective but also adds costs, red tape, and operational inefficiencies.

PUTTING IT ALL TOGETHER: RETHINKING THE SEPARATION OF OWNERSHIP AND CONTROL

The synchronization of the two trends is striking: the flourishing and maturity of private equity against the declining attractiveness of being a quoted company. This may have far-reaching consequences by putting into question the fundamentals of neoclassical finance theory, notably Berle and Means' (1932) influential theory of the modern corporation and the separation of ownership and control. For decades we grew up on the central theses of efficient markets through the invisible hand theory, which allows households and institutions to trade shares in well-functioning financial markets. Since Jensen and Meckling's (1976) ground-breaking agency theory, we became aware of the notion of moral hazard and imperfect corporate governance. Dysfunctional boards, uncorrelated executive pay to performance, earnings management, and the other misalignments described in this article have been recurring concerns in academic research. However, there has never been a real alternative for equity investment. Now, for the first time, there is another way of making large-scale investments by institutions, backing a governance model where objectives are better aligned with investors and where financial results show substantial outperformance and record high cash distributions. The governance structure of private equity, with its value-added and hands-on orientation, may well provide institutional investors with a better alternative to publicly listed companies across the capital structure. One where the mindset of seeking an outright exit provides a timely and disciplined code of action indoctrinated all

[10] High-frequency trading constitutes up to 70% of trading volume in some markets and has an average holding period of around 10 seconds. The investment horizon of portfolio investors has also dramatically shortened, from five years in the 1960s to two years in the 1980s and is today around seven months (source: http: www.independent.co.uk/voices/this-is-how-the-price-of-shares-is-really-decided-a7710076.html).

[11] Sources: Robinson, Fundamental Equity Analytics, UBS Global Research, December 6, 2016, and Wilson and Buenneke (2017). For instance, as of January 30, 2017, Microsoft had $129.3 billion cash on its balance sheet, which represented 27% of its market cap and six years of annual net income. Google's 2016 figures were only modestly less dramatic.

[12] There is a large body of research documenting earnings management and deferral of real investments. Roychowdhury (2006) found evidence consistent with managers manipulating real activities to avoid reporting annual losses. Specifically, evidence suggesting price discounts to temporarily increase sales, overproduction to report lower cost of goods sold, reduction of discretionary expenditures to improve reported margins, and more. See also Xu (2016) on accrual management to avoid losses.

the way down to the plant floor; where performance can actually be measured and general partner reputation is critical for the next fund raising.

Is there supremacy of private equity over its more mature sibling of listed companies? This was also Jensen's (1989) query when LBOs were an innovative phenomenon. With the fortune of observing private equity now as a mature sector, the answers are somewhat different. Certainly private equity has a dominating governance model, but it still does not fit all types of companies. For all its hands-on engagement, in governance and operation, private equity is an expensive source of funding and as such should be mainly transitional capital. For large and mature companies, being traded on an exchange is still a more natural platform; hence, there is no real danger to the stock market, despite the decline in the aggregate number of listed companies.[13] The private and the public models will continue to live side by side in a yin and yang duality with osmosis, whereby companies occasionally migrate from one side of the pool to the other through buyouts, takeovers, or IPOs. However, the balance of powers has changed, and so should our thinking.

ACKNOWLEDGMENTS

I thank Dorian Barak, Edward Gera, Tim Hanford, Scott Richardson, and Lauren Talmor for helpful comments and discussions.

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[13] Interestingly, this is not quite the profile of companies predicted by Jensen (1989) who identified computers and electronics as companies "whose profitable investment opportunities exceed the cash they generate." As with the examples above, the centrality and profitability of this sector exceeded any 20th century predictions, and a large number of companies actually generate more cash than they are able to properly invest.

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