## Private Equity

Equity represents a stake in a company. For example, shares traded on the stock market are also referred to as equities. These traded shares are in publicly-quoted companies. That is companies whose share price is quoted on the stock market. Private equity is a stake in a company which is not traded publicly. Recently there has been a growing trend for investment funds to purchase publicly-traded companies and make them private – their shares are no longer traded on the open market.

There are now some 2,700 private-equity firms, managing assets of $500 billion. They are led by a number of giants, such as KKR and Blackstones. Only two years ago the largest fund was worth $6 billion, but some reports say Blackstones' fund is now worth some $20 billion.

Until recently, private equity concentrated on small- to medium-sized companies. Now, even very large companies are being targeted by the private equity groups. These include J. Sainsbury, a British supermarket chain; and recent talk has also included Dell and IBM.

Private equity is not something new. In the 1980s' leveraged buyouts, (LBOs) were popular. Like private equity companies, LBOs used enormous amounts of debt to finance the purchase of publicly-traded companies. Asset stripping, the sale of parts of the business, then enabled the debt to be paid off, or at least reduced.

The main rationale for private-equity firms is that they are good for the companies they own. They increase value, employment, innovation, and research and development. An important means of adding value is through corporate governance. Unlike the owners of public companies, who tend to be too remote and thinly spread to spend time and money closely monitoring a business, private-equity firms have big stakes. Because their people's careers are on the line, they have a powerful incentive to keep a close eye on things.

However, the financial performance of private equity is questionable. Most of the return comes from gearing. The use of debt magnifies any financial gains because no increase in value has to be paid to the providers of debt. So lenders provide most of the capital,

but the equity holders take most of the gains. Strip out the gearing effect and private equity may only perform as well as a publicly-quoted company. Moreover, research has suggested that only a handful of private equity companies outperform leading stock market indices. The vast majority of the 2,700 private-equity companies are no better at adding value than managers who run publicly-quoted companies.

**Questions**

1. Is it reasonable to assume that firms are profit maximisers?

2. In publicly-traded companies, managers and shareholders are different. Do you think this separation of ownership from control will aid or constrain profit maximization?

3. Why might private equity improve a company's profits?

4. Why might many private-equity companies under perform publicly-quoted companies?