Centre for Research on Socio-Cultural Change

CRESC Working Paper Series

Working Paper No. 31

Private equity and the culture of value extraction

Julie Froud and Karel Williams

CRESC, The University of Manchester

Version 2 - February 2007

For further information: Centre for Research on Socio-Cultural Change (CRESC)
Faculty of Social Sciences, The Open University,
Walton Hall, Milton Keynes, MK7 6AA, UK
Tel: +44 (0)1908 654458 Fax: +44 (0)1908 654488

Email: cresc@manchester.ac.uk *or* cresc@open.ac.uk

Web: www.cresc.ac.uk

The support of the Economic and Social Research Council (ESRC) is gratefully acknowledged.

Private equity and the culture of value extraction

Julie Froud and Karel Williams

(Manchester Business School and Centre for Research in Socio-Cultural Change (CRESC), University of Manchester)

Contact details:

Julie Froud
Manchester Business School
M.19 Crawford House
University of Manchester M13 9PL

Email: julie.froud@manchester.ac.uk
Tel: 0161 275 4018
Fax: 0161 275 4023

Private equity and the culture of value extraction

Abstract

Private equity has become increasingly popular with investors seeking returns greater than those from publicly-traded equity. However, the industry has also been the object of increasing question and criticism, focused on concerns about over-leverage and potential instability, asset stripping, lack of transparency and the large rewards for senior fund managers. This paper presents an analysis and argument about private equity as a rearrangement of claims which allow value capture and value extraction for a relatively small numbers of principals. The paper contrasts the narrative of the industry, which emphasises the social benefits of private equity as well as the returns to investors, with the outcomes of increasing leverage. The paper concludes that private equity is not a new kind of capitalism. Nonetheless, it does have important implications as a consequence of the way that it helps normalise a culture of value extraction which increasingly views companies as bundles of assets and liabilities to be traded.

Keywords:

Private equity, leverage, financial engineering, value extraction, model of capitalism.

Private equity and the culture of value extraction

Introduction

'in many ways a superior model of capitalism'

(The Economist, 27 November 2004 on private equity)

The rapid growth of private equity had, by the mid 2000s, provoked mixed reactions. For *The Economist,* 'the private-equity industry has moved from the fringe to the centre of the capitalist action' and offers 'in many ways a superior model of capitalism'[1]. A few months later, a leading German Social Democratic Party politician was less complimentary when he described private equity investors in Germany as 'locusts' who were stripping assets and destroying jobs[2]. The metaphor was slightly different when *Business Week* described private equity investors as 'gluttons at the gate'[3]. At the same time, the continued growth of private equity was making some fund managers uncomfortable about how private equity funds were using debt to overpay for assets and the chief investment officer of the CalPERS pension fund publicly expressed fears about an asset price bubble[4], which were quietly echoed in the analysis of risks in a British Financial Services Authority (FSA) discussion paper[5]. Both supporters and critics consider the development of private equity to be significant, but does it represent a new business model for capitalism?

The global growth of private equity has certainly been spectacular. Between 1985 and 2005, private equity funds experienced a compound annual growth of 18.5 per cent and in the last few years, growth has been more marked. According to Private Equity Intelligence, private equity funds raised $401 billion in 2006 or nearly 25 per cent more than the $311 billion raised in 2005[6]. The global industry includes a relatively small number of very large American funds like Texas Pacific, Blackstone and KKR, now joined by large British funds like Apax and Permira; some of the large funds are themselves public companies, with many more, smaller unlisted private equity houses. As funds have grown, with $10bn funds now increasingly common, this has allowed larger deals to be done; and the recent trend of syndicate or 'club deals', where several private equity houses work together and contribute finance to a deal, has allowed buyouts of over $30bn with enthusiasts talking up the possibility of $50bn or even $100bn buyouts[7]. The funds' sphere of operation is largest in the USA and UK but the reach is global: bank-based systems are no obstacle when private equity is as (and often more) willing to buy family-held Mittelstand firms as US public companies. Indeed, private equity is increasingly international, when a fund raised in London would typically have half of its fund contributed by US investors and would quite likely invest a significant part of the funds outside the UK or the USA

The technical innovations of private equity can best be understood by noting that the private equity fund turns upside down the assumptions we would make about the public company whose shares are traded on a public market, with most of its capital raised in the form of equity for the benefit of a corporate entity which is a going concern. In contrast, private equity funds are raised mainly from institutions like pension or mutual funds, who cannot exit by selling their stake on a public market. The fund is then typically invested by purchasing between 10 and 20 companies or divisions as operating businesses. The purchase of operating businesses is highly leveraged so that on the standard deal of the 2000s some 70 per cent of the cost of purchase is funded by debt, which reverses the usual capital structure of a publicly held firm. The returns on several tranches of debt are typically capped (and debt may be paid down) so that gains from operating or selling on are concentrated in the hands of the minority who provide equity. Each individual company would normally be disposed of by trade sale or flotation after three to five years and the fund as a whole would be wound up within seven to ten years, with capital returned as and when investments are sold.

The term venture capital is sometimes used loosely and rhetorically as in the titles of the British and European private equity trade associations because it associates private equity activity with entrepreneurial risk taking. But more exactly, venture capital is that part of the private equity business which concentrates on supporting start ups and new businesses in their early stages as, for example, in the case of digital technologies in Silicon Valley. If the distinction is made in this way, only 15 per cent of global private equity funds in 2005 were applied to venture capital, with a further 18 per cent applied to expansion and 67 per cent applied to buy outs. Within the UK and the rest of Europe, venture capital is insignificant: private sector high tech start ups are rare so that venture capital accounts for no more than 5 per cent of private equity funds invested in this region; with more than 70 per cent of funds used to buy out established businesses[8]. This paper, like the European private equity industry, therefore, concentrates on buy outs.

The private equity industry has defended itself against critics and sceptics by constructing a narrative of purpose and achievement which emphasises the broad social gains from the way in which the industry sustains and creates jobs.[9] Thus, the EVCA makes claims about jobs created and the British industry makes claims about jobs sustained; media sources have often repeated the BVCA claim that the UK private equity industry employs or has employed 19 per cent of the private sector workforce[10]. For a different audience, the industry has sold itself to fund investors, as a new asset class which has and will deliver returns that are higher than publicly traded equity and only weakly correlated with stock market performance. The BVCA, claims that over the 10 years to 2005, private equity generated annual returns of around 16 per cent, approximately double that from UK or overseas bonds and equity and comparing favourably with the other high performing asset class, property, which generated around 13 per cent returns over this 10 year period[11].

Our argument in this paper is about the gap between explicit promise and undisclosed outcome. The discursive promise of private equity is about general benefits from the value creation consequent upon a new way of relating finance and management; in our view, private equity represents a rearrangement of ownership claims for value capture which then allows value extraction, particularly for the benefit of the few who are positioned as private equity principals or senior managers in the operating businesses. This alternative view frames our argument about the enduring legacy of private equity after its bubble bursts (or its balloon deflates): the legacy effect of private equity is likely to be a cultural shift which normalises value capture insofar as it helps to institutionalise and normalise value extraction for the few as a practice and motivation for investors and managers within and beyond the Anglo Saxon economies. This argument is developed in a paper which is organised in four sections: the first section considers the narratives through which private equity is represented as a new kind of capitalism by US finance academics and business journalists as well as industry representatives; the second section then considers the rearrangement of ownership claims and explains how financial engineering enables value capture by the few; the third section focuses on the modus operandi of value extraction by analysing two cases; while the concluding section considers how private equity normalises value extraction.

Private equity as 'a purer, more efficient form of capitalism'

The public company and the idea of stock market capitalism do have their defenders when authors like Micklethwaite and Wooldridge celebrate the public company as a great 20th century invention[12]. But, from the 1980s onwards, the public company was seen as problematic for mainstream finance academics in the USA, as well as by some journalists, who continue to dream of a rearrangement of ownership claims and management responsibilities which would deliver a superior form of capitalism with general efficiency gains and social benefits.

The intellectual background is provided by agency theory. Thus, in Michael Jensen's view, the public corporation is a 'social invention'[13] which suffers from a general governance problem about agency insofar as agent/managers do not reliably act for shareholder/principals. Further problems arise in specific circumstances such as industries with slow growth or limited investment opportunities, where managements seem reluctant to return cash to shareholders. Hence, Jensen enthusiastically welcomed the leveraged buy out (LBO) boom in late 1980s America where raiders borrowed money to buy public companies:

> who can argue with a new model of enterprise that aligns the interests of owners and managers, improves efficiency and productivity and unlocks hundreds of billions of dollars of shareholder value?[14]

LBOs supposedly had a kind of governance advantage because the direct and informed personal interests of (a smaller number of) new owners could be more easily aligned with those of managers who were incentivised and controlled more effectively. The (operating) sources of the gains were a bit blurred but Jensen argued that businesses would be better run, creating value 'from real increases in productivity' (p.70). As for debt, it was credited with magical, new qualities. The old view, still represented in the varieties of capitalism literature was of debt as benign or patient capital that allows managers to pursue objectives including investment and growth that might not meet the approval of short-termist public equity markets. Jensen's new view was that debt was very positive because the requirement to meet interest rate payments could discipline managers in a way that largely passive shareholders could not.

Innovation did not go smoothly. Many were not convinced by Jensen's academic arguments and LBOs were questioned by the business best seller *Barbarians at the Gate*[15] and criticised in the Hollywood blockbuster *Wall Street*. The 1980s LBO boom came to a fairly rapid halt, killed off by scandals involving junk bond traders and by a modest turn down caused by rising interest rates, which led to some well publicised defaults on businesses where 90 per cent or more of the purchase consideration had been borrowed. However, falling rates of interest in the late 1990s led to the reincarnation of LBOs as private equity with business journalists repeating the same schtick about how private equity could solve agency problems[16]. Thus, in the Lombard column of the *Financial Times*, Martin Dickson wrote 'private equity is, in many respects, a much purer, more efficient form of capitalism than the public markets'[17]. But the private equity industry still needed to distinguish itself from discredited LBOs and to claim social respectability as well as favourable tax and regulatory treatments. It did so through several distinct performative and narrative means. Thus, the new private equity provided a retirement home for former politicians like George Bush Sr and John Major, as well as distinguished ex-CEOs like Jack Welch of GE and Lou Gerstner of IBM, who added lustre though no one knew quite what role they played.

> In terms of narrative defence, the British and European private equity industries faced public suspicions about asset stripping and job destruction and they responded by commissioning surveys and academic research showing not only the substantial size and superior profitability of private equity sectors but also their record of social responsibility in creating jobs. Thus, the European Venture Capital Association (EVCA) has highlighted the contribution to job creation by commissioning a survey that 'clearly demonstrates that European private equity and venture capital can make a difference to the European economy by providing sustainable, high quality jobs across Europe'[18]. The EVCA claims that a million jobs were created by private equity between 2000 and 2004 and the activity will make a significant further contribution to the EU challenge of creating 20 million new jobs[19]. In the UK, the BVCA claims that private equity has not only created employment faster than other firms, but it has also generated faster growth, more exports and investment so that the industry motif is 'investing in enterprise'[20].

Before considering the modus operandi of 'enterprise', the next section focuses on the sources of returns and about how private equity general partners as financiers rearrange ownership claims to allow value capture by a few managers.

Rearranging ownership claims for elite value capture

The supporters and critics of private equity look for some kind of general private equity effect on financial returns or employment and differ only about whether it is positive or negative. This section begins by explaining why such general effects are unlikely and how the available empirics on financial returns suggest mixed and, in some cases, even mediocre results. It then goes on to explain how financial engineering is used to rearrange claims for the benefit of those who own equity, as well as how the private equity business model ensures value capture by a managerial elite of general partners who run funds and senior managers who run the operating businesses invested in.

The gains from operating and selling-on an individual business within three to five years have several sources. Insofar as the private equity business is dealing in used companies, gains are strongly influenced by the difference between buying and selling price which depends in turn on multiple conditions like the state of the new issues market or the availability of trade buyers at point of sale. As for operating gains, margins might be improved by increasing sales, shuffling product lines or process improvement and/or by reducing labour costs. Returns could also be generated by purely financial means such as taking out a special dividend after refinancing the business and loading it with debt. When there are so many variables and moving parts, it seems inherently unlikely that private equity will have any general effect regardless of sector, time period and the volume of private equity activity itself. The high returns of one period will be sharply reduced in the next if, for example, competition amongst private equity funds bids up the price/earnings ratios paid for businesses and/or if the new issue market turns down cyclically a few years later.

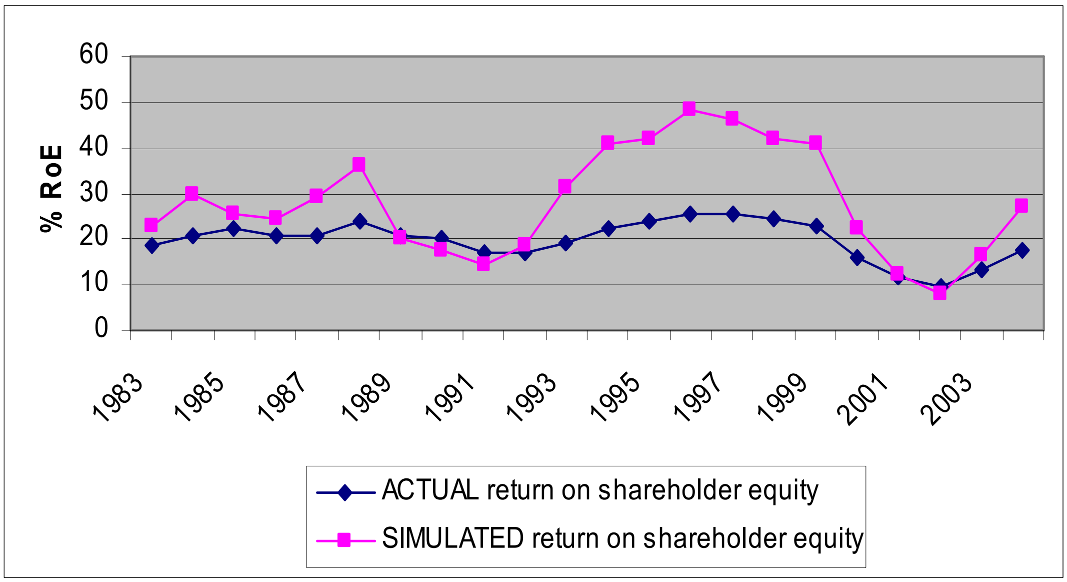
If the effects are complex and variable, we would expect cross section and time series studies to show variable employment effects and financial returns from private equity; there is also no reason to expect that either positive or negative outcomes in one period would hold in the next as general conditions change. Evaluation of effects becomes complicated because there is insufficient publicly available evidence to make any judgement on employment in a way that would allow a comparison of employment trends in private equity and non-private equity held firms. The evidence on financial returns is equally complex. Not only is there a choice of measures (IRR or cash-on-cash), but the time period over which performance is assessed is also relevant, given that many private equity funds exhibit what is referred to as a 'J-curve', where investment returns typically do not appear until several years into the life of the fund as investments are sold. Furthermore many industry claims are based on samples, often of self-reported performance and fail to distinguish between returns on company investments and overall return to an investor whose committed funds are not wholly drawn down. With profit it is often a question of 'now you see it, now you don't'; in one case that we know, the return on money drawn down via investments made was 38% on an IRR basis but the return to the final investor was no more than 16% cash-on-cash after taking into account low returns on committed money, which was not invested but placed on deposit. As we have noted, the BVCA claims superior performance with British private equity returns twice those of public equity, whereas the EVCA calculates 10 year internal rates of return for European private equity, which outperform equity (after the 2000 stock market crash) but 'generate only mediocre returns' against the Eurobond index.[21]

The limited number of academic studies on US private equity are significant because they suggest variability of return within and between funds, with overall average levels of return which are far from exciting. Kaplan and Schoar's important US study found that average buy out returns over the period 1980 to 2001, after fees have been deducted, are approximately equal to those from the S&P500 but with large 'heterogeneity in returns across funds and time'[22]. This variability arises because some funds do indeed produce high returns but equally many others do no better, and often perform worse, than publicly traded equity and, if we consider successful funds, the overall performance of the fund will often depend on a small number of successful investments with losses on others. Using a different sample, Swensen presents results that are essentially similar: for funds formed between 1980 and 1997 he finds that both LBOs and venture capital in the USA produced lower returns than public equity. The uneven returns are captured here in Swensen's calculations of risk: domestic equity produced median returns of 15.5 per cent with a standard deviation of only 1.3 per cent; LBOs were markedly more risky over the same period with a median fund return of 13.2 per cent but a standard deviation of 35.7 per cent[23]. These US studies suggest private equity has not so far generated superior average returns and that these returns come with health warnings about variability and risk.

For those involved in the activity, the attractions of private equity rest not on any record of higher average returns through sharper operating focus or selling on to create value, but on the redistribution of claims and rewards through financial engineering to capture value. The issue is increased leverage via more debt which in the British case involves shifting from a typical FTSE public company structure of 70 per cent equity and 30 per cent debt to a typical private equity structure of 30 per cent equity and 70 per cent debt. In a debt-heavy corporate structure, returns to equity holders are shared out among a smaller number of claimants; if debt is relatively cheap and the returns on borrowed capital are capped, then operating gains accrue to the (private) equity holders who are of course now entitled to all the gains from refinancing or selling. The leverage on equity profit is further increased by the different corporation tax treatment of interest payments and dividends in the UK and USA: interest payments are deducted before corporation taxation is paid and dividends are paid afterwards, so more debt may well be capital efficient. When interest rates are at a 40 year low and corporation tax is around 40 per cent, increasing the ratio of debt in total capital is very attractive for those who will retain (private) equity. The general caution is that the bond holders have a prior claim on earnings, so equity returns will be variable and highly risky *either* if the initial purchase price of the business is inflated *or* if leverage is high as it was in late 1980s LBOs[24]. These benefits and risks of leverage for those who supply a minority of the capital in the form of equity are of course available regardless of what management does at the operating level. Such gains are a matter of arithmetic at the financial engineering level, rather than a consequence of how private equity governance aligns owner and manager interests, and in principle public companies could improve returns to equity by re-leveraging and taking out more debt.

To understand the potential effect of such re-leveraging, we undertook a simulation using the UK's largest 100 firms by market value, the FTSE100, from 1983 to 2005. Over this period, debt typically accounted for 30 per cent of total capital and, as figure 1 shows, actual returns on equity are generally between 15 and 25 per cent, with the exception of 2001-2002 when returns are depressed following the collapse of the 1990s bull market. Let us then, counterfactually, re-leverage these companies in line with private equity practice of the 2000s so that debt accounts for 70 per cent of the capital, with the cost of debt charged at 3.75 per cent over the Bank of England base rate[25]. The result is that returns to equity are generally higher, though with a much greater degree of cyclicality, as figure 1 illustrates. In the cyclical troughs of 1989-1991 and 2001-2002 the simulated returns are slightly lower than those actually achieved. However, in other years a re-leveraged balance sheet produces much higher returns to a reduced equity base: for instance in 1996-1998, returns are approximately doubled by substituting debt for equity and over the period as a whole these firms would produce more for shareholders. The arithmetic of leverage gives similar results in other times and places. In a simulation of the S&P 500, Swensen (2000) finds that re-leveraging US public companies in line with buyout capital structures increases the return to equity holders from 17 per cent to 86 per cent, which is considerably in excess of the 48 per cent return (even before fees) from Swensen's sample of LBOs[26]. Of course, this kind of startling counterfactual does not sketch a sustainable future because de-equitisation on this massive scale would derange the markets for public debt and equity. However, this observation underlines the point that private equity is not a new form of capitalism because its leverage formula is not easily generalisable.

Figure 1. A simulation of the effect on the return on equity (RoE) for UK FTSE 100 companies if they were re-leveraged from 30:70 to 70:30 debt: equity.



Source: *authors' calculations based on FTSE 100 company annual report and accounts.*

Note: the simulation was done by applying typical private equity leverage (i.e. 70 per cent debt) to the FTSE100, assuming a cost of debt of Bank of England base rate plus a 3.75 per cent margin.

The first attraction of private equity is that financial engineering concentrates reward for the benefit of the minority of capital providers who provide equity and caps reward to the majority of capital providers who supply cheap debt. This observation raises fundamental questions about the industry's argument that mass savers can benefit from higher returns if their pension funds invest in private equity funds[27].What is not discussed is that these may well be the same (retired) mass savers who have bought annuities or who are in mature pension schemes that seek fixed interest coupon investments, whose cheap debt finance helps raise private equity returns. Some, more recently, comes from the recycling of Chinese and other Asian trade surpluses which would otherwise increase the pressures for upwards domestic currency revaluations. It is impossible to be sure because we know very little about who ultimately buys the debt that funds a large part of private equity activity. Large buy outs have complex capital structures which incorporate several tranches of debt with different interest and repayment profiles. A Financial Services Authority (FSA) discussion paper observed that, in the UK, the initial purchasers would be a bank as part of a syndicate which arranged the loan financing for a fee and then aimed to sell its debt on within three to six months. The FSA found that half of the banks with private equity underwriting business that it surveyed did not know the final destination of all the debt they subsequently distributed to other banks and financial institutions including hedge funds[28].

The second attraction of private equity is that the private equity business model concentrates equity ownership and fee income in a few hands so that a managerial elite can gain what the *Financial Times* have described as 'life changing amounts of money'[29]. Pension funds and other outsiders who invest in private equity become limited partners with equity stakes but the private equity fund is then managed by a few private equity general partners who earn fees and a share of the profit, while a few senior managers in the operating businesses will often have substantial equity stakes as a form of incentive and reward. General partner rewards take two forms: first an annual management fee of around 1-2 per cent of the value of the fund; and, second, a share of the profits of the fund (known as the 'carried interest' or 'carry'), which is usually about 20 per cent, payable after a hurdle rate of return has been achieved. The management fee skims a first tranche of value from the fund and provides a reward which is completely unrelated to performance and, interestingly, with little evidence of any competition on fee levels. Both new funds and those with a track record will charge very similar fees, which provide increasingly comfortable rewards for those managing large funds given that deal and fund size have increased so that the largest funds now raise £10 billion. The carried interest provides the opportunity to generate significant returns in the form of capital gains for the general manager provided value can be extracted for the equity claimant. In another paper which includes illustrative figures based on real funds we have shown that, in the case of successful mid-market funds, 6-10 partners could expect a carry of £5-15 million after five years; for partners in the much smaller number of very large funds, the rewards might be of the order of £50-150 million.[30] Most of the gains of successful general partners (and their operating managers with equity stakes in the businesses) will be taken not as income but as capital gains, which has huge tax advantages when the higher rate of income tax in the UK is 40 per cent: the *Financial Times* reports gossip that leading British private equity partners have paid tax of no more than 4-5 per cent on multi-million incomes.[31]

The asset class question about whether private equity generates higher returns turns out to be a secondary one because private equity's undisclosed business model is value capture through financial engineering focused on the enrichment of a managerial elite, with mass investors mainly involved in providing the cheap debt which makes the whole thing possible. This elite group is unaccountable because this is enrichment without any proper governance so that general partners of PE funds can effectively levy new fees and charge them against their operating companies or the fund in ways that would be unacceptable if they were senior executives in public companies. Thus, as US critics note, when a private equity firm buys a company it can charge a fee for 'advising' on the deal and this fee may be larger that earned by the investment banks: for example, *Business Week* reports that Blackstone Group took $45 million from buy out target Celanese Corporation for advisory work on its own deal in 2004, more than twice the $18 million which Celanese paid Goldman Sachs its investment bank adviser[32].

The modus operandi and value extraction

If leverage and the business model provide the framework for elite enrichment, the modus operandi is relevant because value has first to be extracted before it can be captured. It is difficult to discus a general modus operandi when private equity adjusts operating tactics to activity and conjuncture differences; so we begin by discussing the relative importance of operating decisions and debt as means of value extraction before turning to consider two cases of value extraction which both represented risky cases for private equity because the cash flows were not secure but the balance sheet was attractive. Little Chef is a chain of British roadside cafes whose offer and format was out of date, and Debenhams, is a British mid-market department store of a kind which struggles to justify its existence.

The standard debate about good and bad private equity is about operating decisions and their direct effect on labour. Critics point to media stories about private equity managers who have closed operating facilities and sacked workers, as in the case of the closure of the Birds' Eye frozen food factory at Hull in the UK after the brand was acquired by Permira from Unilever[33]; just as there must be often unreported good news stories of good operating management focusing management effort and growing the business. But it is unlikely that a combination of cost reduction by sacking workers or good operating management can generally deliver sufficient value extraction to make it a primary tool. In contrast, in the case of mundane, mature businesses where operating turnaround is hard to achieve, we would argue that more financial engineering can usually be applied to generate cash by loading the operating business with debt if the newly purchased business has the a traditional corporate balance sheet which combines assets such as property with low debt. This general formula then defines the field of operation of private equity and its preference for activities like infrastructure, utilities, retailing and media. Such activities are likely to have high and stable cash flows which allow high levels of debt to be put on a company, while barriers to entry or potential consolidation opportunities create medium term opportunities. The impact on the workforce is likely to be indirect over some period of time because if cash flow falters because of cyclical turn down or product failure, the business will have less room for manoeuvre when payments on debt represent a large fixed outgo.

Debenhams has been described as 'textbook' private equity[34], moving from buyout to exit in only 30 months and allowing the owners of the business to more than triple the value of their investment along the way[35]. The company was taken private in 2003 by a consortium of private equity firms (CVC, Texas Pacific Group and Merrill Lynch Private Equity) with a package comprising approximately £1.4 billion of debt and £600m of equity. In May 2006, just under 60 per cent of the company was floated on the London Stock Exchange raising around £600 million and valuing the whole company at £1.7bn. The public offering of Debenhams' shares allowed the process of exiting from the investment to begin, but the returns to equity holders had been assured before this move through a series of financial restructurings which extracted value over the period in private equity ownership. Soon after purchase the property assets were separated from the operating business and remortgaged to release cash to help pay for the buyout.[36] In 2005 the freehold and long leasehold sites were then sold to British Land and leased back in a deal that brought in £495 million. The business was also refinanced twice, first in 2005 using a syndicated loan and, secondly, using a senior debt issue to recapitalise the business and in doing so increase the debt to £1.9 billion. The importance of these refinancings is that they allowed £1.2 billion to be taken out of Debenhams and returned to the private equity consortium as a 'special dividend' worth twice the original equity stake.[37]

The case of Little Chef is in some ways rather different but the story is again one of value extraction. Here the roadside restaurant chain had been put up for sale by its owner Compass Group, which had originally inherited the business following Granada's takeover of Forte in 1996 and the subsequent splitting of Granada into two companies, including Compass. In 2002, private equity group Permira paid £712 million for 370 Little Chef sites and 220 Travelodge hotel sites which were part of the same package. Permira made it clear early on that they intended to dispose of Little Chef and concentrate on the Travelodge hotel business which it deemed more attractive. Between 2002 and 2005, some 137 Little Chef sites were closed and, in 2005, the Little Chef brand and the remaining 233 restaurants were bought by a much smaller private equity fund, People's Restaurant Group, for £52 million. As with Debenhams, the private equity owners undertook a sale and lease back, in this case of 65 freehold sites which raised £60 million to help pay down some of the debt. However, this introduced a new obligation to pay rent on the sites which became difficult to meet and the business was put into administration at the end of 2006. In early January 2007, Little Chef, was sold to its third private equity owner, RCapital, in association with Arazim, the property company that had bought the sites from the previous management. This time the deal was thought to have been around £10 million[38] for a brand and a collection of leasehold sites, some still owned by Travelodge.

Debenhams is different from Little Chef in the sense that one was a successful investment for private equity and the other was probably not. But, there are strong similarities in that in both cases the scope for value creation was limited because it was nearly impossible to transform the fundamentals of the operating business. Debenhams recruited and incentivised operating management with previous experience of retail buy out and resale (*Financial Times* 2 May 2006).They tried hard by reducing the numbers of suppliers, tightening terms with creditors, reducing capital expenditure and focusing on brand retailing, which together raised the operating margin from 12 to 15.8 per cent[39]. But, as the subsequent mixed record shows, the margins and market share of this mid-market department store remains under pressure in a highly competitive retail sector. Little Chef's management failed to make over the faded brand and food offering. But the fundamental problem was that competitors were providing more attractive offerings, so that many believed, like *The Times,* that Little Chef 'was doomed before the new barbarians arrived at its gate'[40]. Although Little Chef has not been hailed as an example of effective private equity, there are important similarities with Debenhams because the story of private equity ownership in both cases is one of extracting value through refinancing.

The extraction of value is pure financial engineering because the operating business acquires liabilities in the form of debt equal to the sum of cash taken out. But the cash goes into the hands of elite private equity providers and fund managers while the liabilities are passed on with the business[41]. Consequently, in Little Chef and Debenhams, after a period in private equity ownership, the next set of owners and managers have a considerably different set of assets and liabilities and this in turn helps to frame a more restrictive set of future options. In the case of Debenhams, not only had all the freehold sites been sold (leaving a liability for rental payments) but the business also had considerably more debt (£1.9 billion) when it went back onto the public market than it had at the time of the buyout when the retailer was very modestly geared with only £100 million of debt. The company is now faced with significant interest payments and a need to pay down debt which will reduce future cash generation. For Little Chef, the restructuring of the company's balance sheet proved near fatal and in the end compromised the value that could be extracted at the point of exit, though it is unclear whether it allowed interim payments to be made to equity holders. In a similar way, *Business Week* cites cases in the USA where firms have 'been forced into Chapter 11 because their growing debt left no room to deal with operational challenges such as sudden spikes in materials prices'[42], confirming that the process of value extraction can sometimes go wrong.

The clear implication of this analysis is that private equity is not a new model because it is self limiting. The modus operandi in mundane businesses is a kind of asset stripping which leaves behind spoiled balance sheets and the supply of suitable operating businesses at point of purchase will ultimately be smaller than the funding available, while at point of sale the public markets or trade buyers may be more wary of the likes of Debenhams where it is not clear that there are value creation possibilities for the next set of owners. Meanwhile, the velocity of dealing appears to be increasing, with some private equity owners pursuing what is known in the business as a quick 'flip' after short ownership periods; this churning is difficult to reconcile with the trade narrative of a nurturing form of capitalism. Another sign of pressure is the growing importance of secondary deals (where the acquired operating business is sold to another private equity firm rather than passed on via a trade sale to another company, or floated on a stock exchange): by 2005 in the UK, secondary deals accounted for one third of the value of new private equity deals; there were 35 secondary buyouts in 2001, which rose to 87 in 2004, valued at £7.1bn[43]. This serves to normalize the pursuit of value through financial re-engineering as businesses become bundles of assets that can be sold, unbundled, sold again through several cycles of refinancing for value extraction.

Implications and conclusions

Private equity is an innovation that shows how present day capitalism escapes the boundaries imagined in social science literature, such as that on national varieties of capitalism where equity and debt figure as the basis of national systems. Private equity couples equity and debt for value extraction, which creates a different structure of claimants compared with publicly-traded equity, but it generally benefits the few. Private equity also ranges across national boundaries: the practice of private equity may come out of anglo-american capitalism but its scope and application is now much broader. Thus, US buyout houses were part of all the €3bn plus deals in Europe and more than one quarter of all European deals of more than €400m since 2003; meanwhile 45 per cent of UK private equity funds were invested overseas in 2004[44]. It is widely acknowledged that Europe provides better private equity opportunities than the USA, and the more adventurous funds are increasingly looking further afield at India, Russia and China[45].

Private equity funds have been unflatteringly described as 'new conglomerates'[46] in that they acquire often unrelated businesses on the basis of trading not keeping. Despite attempts to cultivate a narrative of social and economic efficiency, the industry is starting to attract negative comment about both process and outcomes, not unlike that directed at earlier 'asset stripping' conglomerates like Hanson. The US Department of Justice is announced an investigation in 2006 into allegations of collusion in so-called 'club deals' where several private equity houses make joint bids for larger public companies.[47] In response, the industry is doubling its efforts at educating media, regulators and investors about transparency as well as social benefits [48].

The conjuncture of cheap debt and rising stock markets created a boom in private equity in the mid-2000s. But, this is likely to be short-lived because when the economy turns down and interest rates go up, or when quick flips and greed get out of hand, it will all end badly. According to Standard and Poor's, the ratio of debt to company cash flows reached 5.7 in the fourth quarter of 2006 (up from a ratio of 4.0 in 2002); the last time this debt ratio was so high was in the mid-to-late 1990s.[49] We do not know whether it will end with a bang or a whimper because we do not know who ultimately holds the debt or how far the industry will go collectively in paying fancy prices and pushing up leverage. However, it is quite likely that any crisis would be followed by disclosure of malpractice and conflicts of interest, which may lead to years of litigation by aggrieved outside investors.

Private equity is an investment strategy not a new institutionalised form of capitalism but it does add to the stock of knowledge and technique about how debt and equity can be mixed and about how a firm is more than an operating business with a price-earnings ratio. There are several likely legacy effects including increased velocity of restructuring and the spread of financial engineering as firms are sold and resold. This would involve further assault on the traditional, mainly public equity financed company, which is likely to have to adapt to post-private equity practice such as increased leverage and trading businesses and assets as a source of profits. The narrative around private equity may become less important in future if one of the legacy effects is the normalisation of a business culture of asset bundling, unbundling and dealing, with not enough critical questions asked about value capture and value extraction for elite managers. Financial engineering in the form of leverage and sale and lease back are likely to become general management tools (provided interest rates are low) and already there are signs that some public companies are acting defensively in such ways to make themselves less attractive as targets for private equity[50].

Finally, it is unclear whether private equity will also normalise expectations about returns to investors that are much greater than those that can be earned through investing in productive and financial companies. As we have shown elsewhere, as a collective group the largest public companies in the UK and USA grow no faster than GDP,[51] which puts an effective cap on returns to those who invest in a portfolio of such firms. The quest for alternative investments, like private equity, hedge funds or property, is partly driven by some investors seeking higher returns. Insofar as such expectations spread and become normalised, the quest for 'value' obscures important differences between value creation and value capture and extraction, with important implications for other stakeholders.

---

[1] Anonymous, 'The new kings of capitalism', *The Economist* 27 November 2004, p.3.

[2] Anonymous, 'Locust, pocus – German capitalism' *The Economist,* 7 May 2005, p.75.

[3] Emily Thornton, 'Gluttons at the gate, *Business Week* 30 October 2006.

[4] Peter Koenig, 'Is private equity building up a debt bubble', *Sunday Times*, 6 March 2005, Business p.1.

[5] Financial Services Authority (FSA) *Private Equity: a Discussion of Risk and Regulatory Engagement,* Discussion Paper 06/6 (London, 2006).

[6] Anonymous '2006 fundraising smashes all previous records', Private Equity Online, 5 January 2007 (available at: http://www.preqin.com/article.aspx?articleid=233 accessed 15 January 2007).

[7] See, for instance: Jason Singer & Henny Sender, 'Leading the news: private equity gets ever bigger to pay for buyouts. New cash lets firms ponder deals valued above $50bn', *Wall Street Journal Europe,* 26 October 2006, p.3; Steve Rosenbush, 'Private equity: what's the limit?', *Business Week,* 8 December 2006.

[8] International Financial Services London (IFSL) *Private Equity,* City Business Series (IFSL, October 2006) p.8. Available to download at: http://www.ifsl.org.uk/uploads/CBS_Private_Equity_2006.pdf (accessed 15 December 2006).

[9] See, for example: British Venture Capital Association (BVCA) *The Economic Impact of Private Equity in the UK 2006,* (London, 2006); BVCA *Private Equity – a UK Success Story,* (London, 2006); European Private Equity and Venture Capital Association (EVCA).

[10] British Venture Capital Association (BVCA) *The Economic Impact of Private Equity in the UK 2005,* (London, 2005), p.6. In its 2006 report, the BVCA also for the first time estimated the number of people by companies currently backed by private equity: this was estimated to be 1.2 million, or 8 per cent of the private sector employees (BVCA, *The Economic Impact of Private Equity in the UK 2006*, (BVCA, 2006), p.5).

[11] IFSL, Private Equity, p.4

[12] John Micklethwaite & Adrian Wooldridge, *The Company: a Short History of a Revolutionary Idea,* (Weidenfeld, 2003).

[13] Michael Jensen 'The eclipse of the public corporation' *Harvard Business Review* September-October 1989, p.64

[14] *Ibid* p.72

[15] Bryan Burrough & John Helyar, *Barbarians at the Gate. The Fall of RJR Nabisco,* (Harper Collins, 1991).

[16] According to the *Wall Street Journal*, 'private equity' was introduced as a euphemism for the discredited term, LBO. See: Matthew Monks, 'Private equity stars play name game', *Wall Street Journal,* 4 October 2006.

[17] Martin Dickson, 'Why private equity is a pure form of capitalism. Disadvantages of the public company market' *Financial Times*, 12 November 2005, p.16.

[18] European Private Equity and Venture Capital Association (EVCA) *Employment Contribution of Private Equity and Venture Capital in Europe,* (EVCA, 2005) executive summary p.3.

[19] *Ibid* p.4

[20] 'Investing in enterprise' is the motif of the BVCA.

[21] McQueen, *Private Equity: Visionaries or Locusts?* (McQueen, 2006), p. 11. Available to download from: http://www.mcqueenltd.com/News.aspx (accessed 20 January 2007).

[22] Stephen N. Kaplan & Annette Schoar, 'Private equity performance: returns, persistence and capital flows,' *Journal of Finance,* vol.60, no.4 (2005), pp.1791-1824, p.1792.

[23] David F. Swensen, *Pioneering Portfolio Management. An Unconventional Approach to Institutional Investment,* (The Free Press, 2000), p.228.

[24] For example, the 1986 buyout of Safeway by KKR was 96 per cent debt-funded.

[25] The 3.75 per cent margin produces a cost of debt that is higher than many funds (or corporations) would typically be charged. Thus any bias in the simulation would be to the disadvantage of the return of re-leveraged FTSE 100 companies.

[26] Swenson Pioneering Portfolio Management, p.231.

[27] BVCA, *Private Equity – the New Asset Class.* Highlights of the London Business School report 'UK Venture Capital and Private Equity as an Asset Class for Institutional Investors' (BVCA, 2000). See also the Myners report which encouraged institutional investors to give more consideration to private equity as an asset class: HM Treasury, *Institutional Investment in the UK: a Review* (The Myners Report), (HM Treasury, 2001), chapter 12.

[28] FSA Private Equity: a Discussion of Risk and Regulatory Engagement, para 3.77.

[29] Dan Roberts, 'Hyper-capitalism', *Financial Times,* 2 May 2006, p.20.

[30] For more discussion of the business model of private equity see: Peter Folkman, Julie Froud, Sukhdev Johal & Karel Williams, 'Working for themselves: capital market intermediaries and present day capitalism' *Business History,* (2007, forthcoming).

[31] Peter Smith, 'A public relations offensive on the buy-out high-wire' *Financial Times,* 26 January 2007, p.15.

[32] Emily Thornton, 'Gluttons at the gate, *Business Week* 30 October 2006.

[33] Barry Clement, '500 jobs are axed as Birds Eye shuts plant' *The Independent,* 12 January 2007.

[34] According to the Ernst and Young director of retail: It's so significant because of the magnitude of the turnaround in a relatively short timescale' (*Retail Week*, 5 May 2006).

[35] Anonymous, 'Debenhams', *Financial Times* 31 May 2006, p.2.

[36] Anonymous, 'Debenhams' return to the LSE ensures saga ends well for all', *The Lawyer* 8 May 2006, p.13.

[37] Jonathan Braude, 'Debenhams to make debut' *TheDeal.com,* 21 April 2006.

[38] Simon Bowers & Julia Kollewe, 'Turnaround experts engineer a roadside rescue for Little Chef', *Guardian* 4 January 2007, p.21.

[39] Elizabeth Rigby, 'Back on the shelf: Debenhams has to sell itself as it returns to the stock market', *Financial Times* 21 April 2006, p.19.

[40] Robert Cole, 'Doomed before barbarians arrived', *The Times* 4 January 2007, p.45.

[41] The idea of refinancing the company to allow value to be extracted, as in the case of Debenhams, is not an isolated case. The *Wall Street Journal* reports that between 2003 and mid-2006, some $69 billion was borrowed by (US) companies 'primarily to pay dividends to private-equity owners'; in the six years to 2003, the equivalent sum was $10 billion. See, Greg Ip & Henny Sender, 'Private money: the new financial order', *Wall Street Journal,* 25 July 2006, p.A1.

[42] Emily Thornton, 'Gluttons at the gate, *Business Week* 30 October 2006.

[43] Centre for Management Buy-out Research (CMBOR), *Exit* (CMBOR, University of Nottingham, 2005).

[44] *Real Deals* 7 April 2005

---

[45] See, for example: Nandini Lakshman, 'Private equity invades India', *Business Week,* 8 January 2007.

[46] Peter Temple, *Private Equity: Examining the New Conglomerates of European Business,* (Wiley, 1999).

[47] Dennis K. Berman and Henny Sender, 'Private equity firms face anticompetitive probe', *Wall Street Journal,* 10 October 2006, p.A3.

[48] See, for example, Peter Smith 'A public relations offensive on the buy-out high-wire' *Financial Times* 26 January 2007, p.15.

[49] Serena Ng 'Moving the market – tracking the numbers', *Wall Street Journal*, 27 December 2006, p.C1

[50] Dennis K.Berman 'Will private equity suffer a push-back? The era of easy deals may be nearing end; holders demand more' *Wall Street Journal Europe,* 3 January 2007, p.19.

[51] Julie Froud, Sukhdev Johal, Adam Leaver & Karel Williams, *Financialization and Strategy. Narrative and Numbers*, (Routledge, 2006).