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Private Equity Funds Pillage the Public Markets

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I suspect that until recently many investors had never heard of a Private Equity Fund. These funds have been around for years but are starting to gain more attention as they grow in size and market impact.

We used to call these companies Leveraged-Buyout (LBO) firms but now use the term Private Equity as their businesses changed slightly. Kohlberg Kravis Roberts & Co. (KKR) is one of the oldest and best known firms in this business. KKR became almost a household name in 1988 when it purchased R. J. Reynolds in the largest leveraged buyout up to that time. A great book, "Barbarians at the Gate," chronicles the event.

Private Equity firms have been very active this year in the Mergers and Acquisitions field (M&A) and account for 34 percent of all takeovers, up from about 20 percent last year.

Generally speaking the stock market likes M&A activity. Investors use the logic that if a buyer is willing to pay more that the current market price for a company, that company and maybe the entire market is undervalued. This logic rests on two key assumptions:

- The target really is undervalued.
- The remaining companies in the market are similarly undervalued.

Let's step back to point out that there are two types of M&A buyers: strategic and financial. Strategic buyers are usually in a related business and planning to integrate the target into their operations. Financial buyers on the other hand see an opportunity to invest for a few years; earn a decent return by using debt and improving management; and then selling the company back to the public in an initial public offering (IPO).

The assumption that the target is cheap is more likely to be true with strategic buyers than with financial buyers. To appreciate why, we need to understand that financial buyers, like Private Equity Funds, make money investing other people's money. Even when opportunities become scarce, they continue raising and investing money. It is hard to get off the treadmill because competitors will just pick up where they leave off.

Of course, the Private Equity Funds want to do a good job for their investors and do not make poor acquisitions on purpose, but raising and investing money is their overwhelming motivation. These funds will invest in the "cheapest" acquisition targets, but that does not necessarily mean the target is "cheap!"

Another problem is that institutional investors plowing money into these funds are somewhat disconnected from the actual investments. The "high-level" decision to invest in Private Equity is often made by committee and the ultimate investors are at least one step removed

from the nitty-gritty of deciding which company to buy. It is relatively easy for a pension plan to put $100 million into a reputable fund. However, if they had to take responsibility for each company that was bought, the investors might be more cautious and slow investments as opportunities dwindled.

The second assumption that "The remaining companies in the market are similarly undervalued?" is more difficult to judge, but I suspect it is wrong. The typical strategy for Private Equity firms is to add significant amounts of debt to the companies they buy in order to increase the potential earnings for the new owners. I have no doubt that Private Equity firms have the skill to cherry-pick the best companies where this will work. This means the remaining companies are not necessarily undervalued.

This brings us to the sticky point that the leaders of many buyouts are the target company's current management. The rub is that these executives have inside knowledge of the company's prospects and are taking the company private for their own benefit. How can these executives, who have a fiduciary duty to shareholders, justify using their knowledge to take it private? Simply put, how can the company's management recommend shareholders sell their shares at a price that they themselves are more than willing to pay for them?

Another conflict of interest for senior executives is "change of control" payments. This is where huge payments are guaranteed to executives if there is a change in company ownership, even if it is a friendly transaction. This results in senior executives, who recommend Private Equity deals, either getting rich by being included in the buyout team or by taking a walk with millions of dollars of our money - pretty cool!

The SEC should get involved as it is their duty is to protect shareholders, but don't hold your breath. A possible solution, that bears some study, would forbid senior executives with minority holdings from participating or entering into any type of agreement with the buyout funds; or receiving change of control payments in friendly deals.

Donald Gogel, the President and CEO of Clayton, Dubilier & Rice; a large Private Equity firm, outlined the virtues of Private Equity in The Wall Street Journal this week. Many of his points were well taken especially on how buyouts can lead to better and more aggressive strategies and that public companies are holding too much cash. I just wish he would run his business without co-opting the managers who are supposed to have fiduciary responsibilities to public shareholders. He brags of the performance of Private Equity firms, but they **should** outperform - given their inside knowledge and the skewed incentives of senior executives.

At some point this Private Equity cycle will end and probably cause a major correction in the market, but who knows when. This happened in October of 1989 when financing in the junk bond market dried up as investors started to question the wisdom of the deals. The collapse of United Airlines' leveraged-buyout was the catalyst for investors realizing the emperor had no clothes. We need the SEC to act before this happens again.

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