

Andrew Rothery

## In defence of the Barbarians

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Andrew Rothery



One of my favourite television shows when I was growing up was the American crime drama *Dragnet*. The central character, Sergeant Joe Friday, gained notoriety for a response he once gave to a wild-eyed witness's account of a crime, "All we want are the facts, ma'am." While it would be overstating the case to label recent reports in the financial press about prospective IPOs of private equity-owned businesses as wild-eyed, some of the commentary regarding how private equity (PE) goes about its business demands correction.

So let me put the facts on the table as I review some of the more egregious comments which have been made in this regard.

"This IPO is another example of how PE firms rip and flip." Another phrase which has been used somewhat interchangeably with "rip and flip" is "pump and dump". In the former case, the allegation is that the only value added by the PE firm which owns the business is its "ripping out" of costs and cash before "flipping" the business into the public market via an IPO. In the latter case, the alleged value added is some temporary ramping up of sales and profits before "dumping" the business into the laps of public market investors.

The language used leaves the reader in little doubt about the regard the author has for the value-adding ability of PE firms. Now I don't think that any seasoned observer of PE would deny that many of the early buyouts completed in the US in the 1980s and 1990s saw the vast majority of the PE firms' returns generated by a combination of leverage and reductions in costs and working capital.

Bloated and lazy public companies were the low hanging fruit for PE in the US in the 1980s and 1990s and in Europe starting perhaps a decade later. Why do anything more when this simple recipe generated such wonderful returns? Professor Michael Jensen provided all the intellectual legitimacy that PE firms could crave in his seminal article in the *Harvard Business Review* in Sept-Oct 1989 entitled *Eclipse of the Public Corporation*. Suddenly it was all about removing the agency costs inherent in the ownership and management structures of public companies. Indeed, it was then very much about that as far as PE was concerned.

The reality is that PE moved on a long time ago. There are very few businesses around today to which the simple "gear it up and slash the costs and working capital" formula can be applied. For many years now PE firms in North America, Europe and Australia have been far more focused on investing in and growing the businesses they own. That's not to say that PE firms don't keep a close eye on costs and working capital management - far from it. But they realise full well that they will be well rewarded only if they present to buyers, whether other PE firms, public market investors via IPOs or corporations, businesses which are in good corporate health. Those buyers and their advisers will look right through rosy sales and profit figures which have been temporarily pumped up. And they will not be fooled by overly optimistic financial forecasts.

I'd encourage investment analysts and financial journalists to spend some time talking to PE firms about what they actually do. They might be surprised. I suspect they will also be surprised to learn that the vast majority of principals of PE firms are dedicated to building and growing their own firms over the long run. They are acutely aware of the need to be respectful of other financial market participants and of the need to co-exist with them.

"Look out! The PE firms are selling at the top of the market!" What else would you expect them to do? PE firms owe fiduciary obligations to their investors to maximise returns over the long run. They can be expected to sell when markets for the assets they own are strong. Nothing more needs to be said on this score.

"If this business is as good as the PE guys say it is, why are they selling it?" The reality is that they have to sell it, eventually. PE firms raise investment capital for closed ended funds, typically with a life of 10 years. Broadly, the first five years are spent investing the capital, the second five are spent managing and harvesting their investments. With limited exceptions, investors do not allow PE firms to recycle capital or extend the life of funds. PE firms simply cannot sit on assets forever. Institutional investors in PE actually like this about PE funds.

Accordingly, the ownership of a business by a PE firm can only ever be an interim form of ownership. The institutional investors which support PE firms around the world are invariably investors in public markets as well. They see PE as fulfilling a useful role in either preparing a business for life in public markets or taking businesses out of public markets to shake them up and re-energise them for a return to public markets a little further down the track. It's often the privacy afforded by PE ownership which allows managers to take hard decisions which will serve the business well in the long run, but which probably won't be rewarded by public markets in the short run.

"The PE guys are pricing the shares to be sold in this business way too highly." I'll let you in on a little secret: buyers always say this. And they have always said this. It's in the interests of the people on the sell side of the table to talk the price up and it's in the interest of the people on the buy side of the table to talk the price down, regardless of the identities of the parties on either side of the table. At the end of the day securities markets are populated in the main by consenting, intelligent, well educated, mature human beings. They can and will make their own decisions about prices at which they will sell and prices at they will buy, based on skill, common sense and experience.

"The PE firms are cutting and running in these IPOs. They should leave more skin in the game." There has been a lot of comment in the press recently around the issue of how much of their holdings PE firms and PE-backed managers should sell into IPOs. Clearly, there are competing interests here: PE firms demonstrating confidence in the future value of the businesses they are selling by retaining meaningful equity stakes versus there being little or no overhang in the form of shares retained by the people who must sell eventually, namely, the PE firms. A couple of sagacious financial scribes have observed that the issue of how much equity PE retains is secondary to the issue of the health of the business being sold. Like the issue of pricing the IPO, the issue of how much equity the PE people retain after the IPO is best negotiated on a case by case basis by consenting, intelligent adults.

I'd like to finish with a suggestion. Complaints about PE firms "fleecing" buyers remind me of complaints levelled against banks for profiteering via the fees and interest they charge. My response to such complaints about banks is to suggest that the complainers get onto the other side of the table by buying shares in the banks. In the case of PE, I realise that one can't just go out and buy interests in PE funds. But the next time you are worried about PE funds fleecing you all, dig a little into the details of your superannuation investments. You just might be surprised to find that your super fund trustees have made some investments in those very same PE funds which are allegedly doing all the fleecing. Australian superannuation funds account for 55% of the capital committed to Australian PE funds. And don't be fooled by assertions that foreign PE firms investing in Australian businesses mean that all the profits will be spirited away from our shores forever. Australian superannuation funds are increasingly global investors in PE. You might also be surprised at how much of those profits find their way back into Australians' superannuation accounts.

As Sergeant Joe Friday also once said: "All we know are the facts, ma'am."

The Australian Financial Review

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