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How Private Equity Works

By JONATHAN MACEY

Mitt Romney's candidacy is subjecting the entire private-equity industry—where Mr. Romney spent most of his business career—to vicious attacks by journalists and several of his rivals for the Republican presidential nomination.

Newt Gingrich's political action committee is sponsoring a film called "When Mitt Romney Came to Town" that accuses Mr. Romney and his former company, Bain Capital, of taking over companies, looting them, and then tossing their workers out on the street. Jon Huntsman's attacks on his rival include the description of private equity as a business that "breaks down businesses [and] destroys jobs, as opposed to creating jobs and opportunity, leveraging up, spinning off, [and] enriching shareholders."

This is anti-capitalist claptrap. Private-equity firms make significant investments in companies, mainly U.S. companies. Most of their investments are in companies that underperform industry peers. Frequently these firms are on the brink of failure.

Because private-equity firms are, by definition, equity investors, they make money only if they improve the performance of their companies. Private equity is last in line to be paid in case of insolvency. Private-equity firms don't make a profit unless their companies can meet their obligations to workers and other creditors.

The companies in which private-equity investors are able to turn a profit generally grow, rather than shrink. This is because the preferred "exit strategy" by which private-equity firms profit is to take the private companies in which they invest and enable them to go public and sell shares that will help the company grow even stronger. As for turnaround success stories, Continental Airlines, Orbitz and Snapple have all benefitted at some time from private-equity investment.

Or take Hertz. Ford sold Hertz to private-equity investors in 2009 for $14 billion. These investors were able to take the company public less than a year later at an equity valuation of $17 billion. The Hertz success story is consistent with the empirical data that indicate companies owned by private-equity firms typically outperform similar companies that do not have a private-equity investor (as measured by profitability, innovation and the returns to investors in initial public offerings).

Private-equity firms not only help corporate performance, but in the long run they lead to more employment and higher wages as well. The alternative to the leaner, smaller firms created by private equity are bankrupt firms that do not employ anybody. And private-equity firms tend to use more incentive-based pay than other firms. A 2008 Government Accountability Office

(GAO) report shows that the companies in which private-equity firms invested had low employment growth relative to their peers, and their employment growth rose after they were acquired by a private-equity firm.

These sorts of facts are an inconvenience for some. One U.S. business publication recently announced that "The U.S. Cannot Have a Private Equity President." The article by Forbes.com writer Robert Lenzner goes on to say that there was only one transaction in which Bain paid a significant dividend, so Mr. Lenzner could make the case that the private-equity industry is one of "company stripping, the ruthless way for a raider to exploit a weakened prey for its own profit," and he could add that "slightly more than a handful" of the deals that Romney did "went bankrupt."

By law, a company cannot pay a dividend unless it is solvent. It also is illegal for a director to authorize a dividend that would render a company insolvent. Corporate boards as a matter of standard practice are extremely careful about paying dividends. This is especially true for companies with board members who are sophisticated and wealthy private-equity investors, because they face personal liability for authorizing the payment of dividends by an insolvent company.

The Forbes article also goes on to assert, in the same vein as many other attackers, that "the nature of private equity is to be ruthless and only care about using as much borrowed money as possible in order to gin up the potential return on equity."

Such an accusation fundamentally mischaracterizes the relationship between debt and equity. Equity investors do not get paid until the creditors do. Moreover, unless those lending money to the portfolio companies of private-equity firms are abjectly incompetent, they will not lend to companies that are not highly likely, if not virtually certain, to be able to repay it. In fact, the leverage ratios—meaning the amount of debt that a company has in proportion to its equity—of private-equity firms declined dramatically during the financial crisis, and they are only now rebounding.

At the height of the financial crisis in 2008, the GAO's private-equity report observed that academic research "generally suggests that recent private equity LBOs [leveraged buyouts] have had a positive impact on the financial performance of the acquired companies." The same GAO report noted that in the 2004-2008 period it studied, none of the 500 complaints received by the Securities and Exchange Commission's Division of Investment Management involved private-equity fund investors. The GAO also noted that institutional investor associations and bar associations reported that "fraud has not been a significant issue with private equity firms."

Unlike some other investors who trade in debt and derivatives, private-equity firms make money by investing in businesses that make things and provide services. This industry should be applauded, not attacked.

Assaults on the private-equity industry really are attacks on economic freedom, because the private-equity process is nothing more and nothing less than free-market capitalism at work. Shame on all the people, particularly those who claim to be friendly to capitalism, who attack Mitt Romney because of his association with the U.S. private-equity industry.

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