Businessweek | Finance

Everything Is Private Equity Now

Spurred by cheap loans and investors desperate to boost returns, buyout firms roam every corner of the corporate world.

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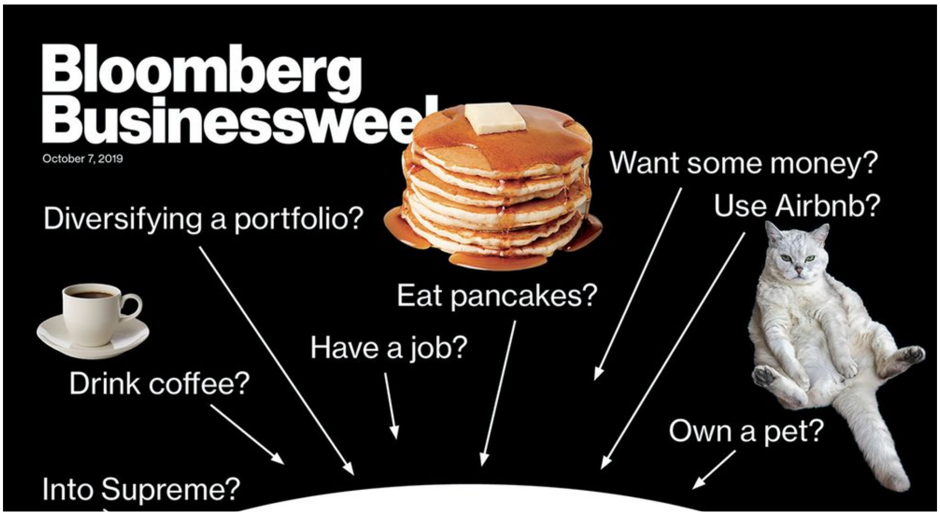
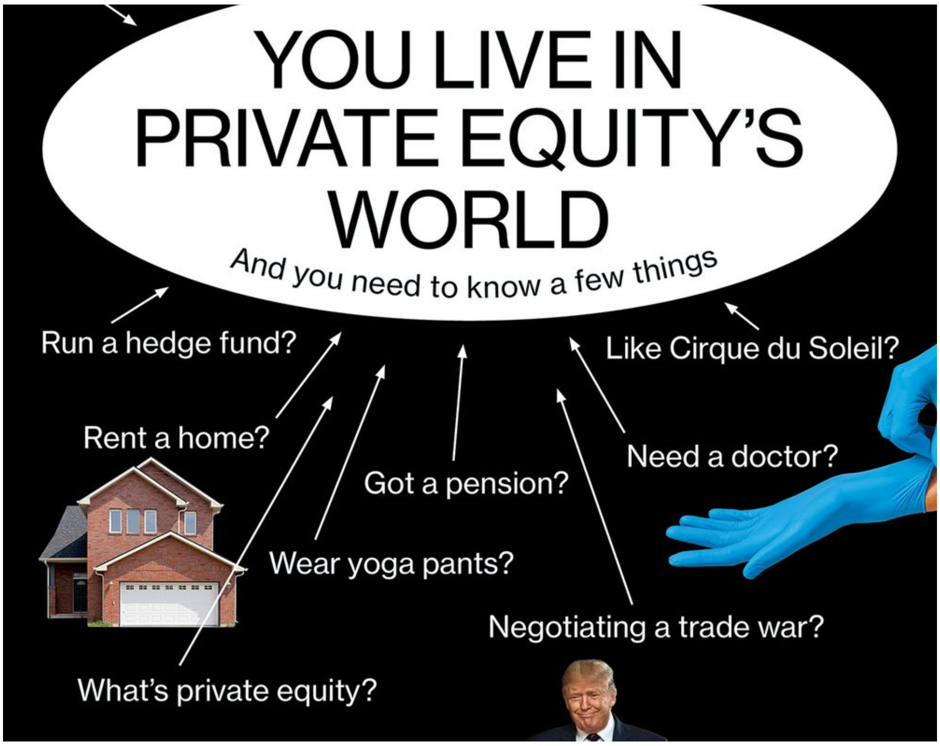
ILLUSTRATION: IGOR BASTIDAS FOR BLOOMBERG BUSINESSWEEK

Private equity managers won the financial crisis. A decade since the world economy almost came apart, big banks are more heavily regulated and scrutinized. Hedge funds, which live on the volatility central banks have worked so hard to quash, have mostly lost their flair. But the firms once known as leveraged buyout shops are thriving. Almost everything that's happened since 2008 has tilted in their favor.

Low interest rates to finance deals? Check. A friendly political climate? Check. A long line of clients? Check.

The PE industry, which runs funds that can invest outside public markets, has trillions of dollars in assets under management. In a world where bonds are paying next to nothing–and some have negative yields–many big investors are desperate for the higher returns PE managers seem to be able to squeeze from the markets.





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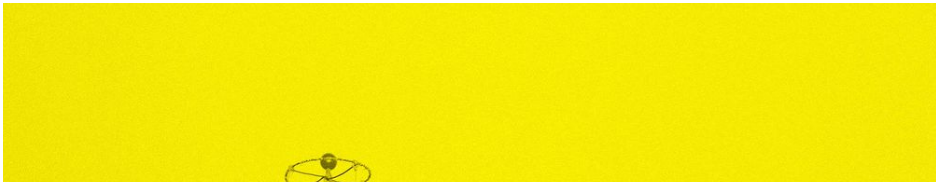
The business has made billionaires out of many of its founders. Funds have snapped up businesses from pet stores to doctors' practices to newspapers. PE firms may also be deep into real estate, loans to businesses, and startup investments—but the heart of their craft is using debt to acquire companies and sell them later.

In the best cases, PE managers can nurture failing or underperforming companies and set them up for faster growth, creating outsize returns for investors that include pension funds and universities. But having once operated on the comfortable margins of Wall Street, private equity is now facing tougher questions from politicians, regulators, and activists. One of PE's superpowers is that it's hard for outsiders to see and understand the industry, so we set out to shed light on some of the ways it's changing finance and the economy itself. –*Jason Kelly*

QuickTake: Private Equity



Photographer: Andrew Rich/Getty Images

The Magic Formula Is Leverage … and Fees

PE invests in a range of different assets, but the core of the business is the leveraged buyout

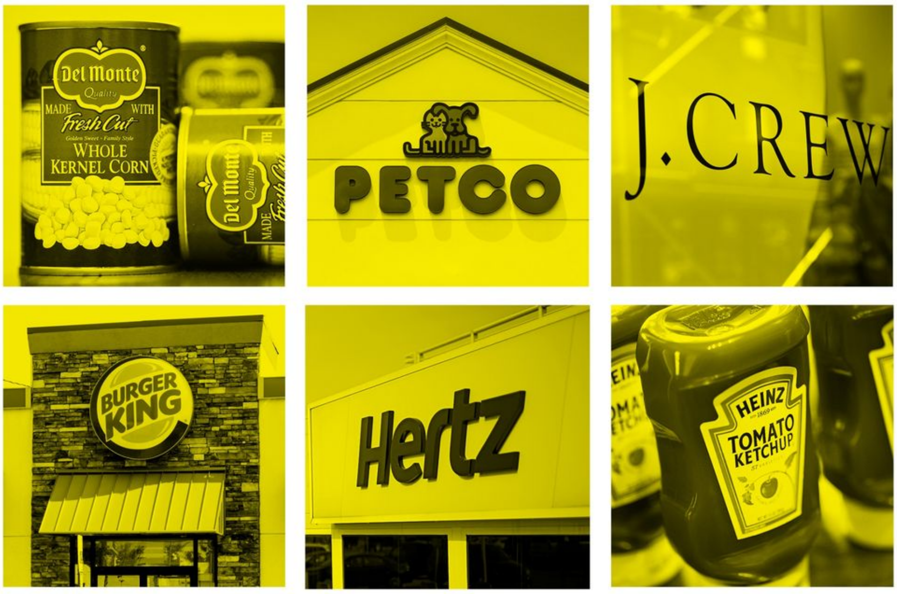
The basic idea is a little like house flipping: Take over a company that's relatively cheap and spruce it up to make it more attractive to other buyers so you can sell it at a profit in a few years. The target might be a struggling public company or a small private business that can be combined—or "rolled up"—with others in the same industry.

1. A few things make PE different from other kinds of investing. First is the leverage. Acquisitions are typically financed with a lot of debt that ends up being owed by the acquired company. That means the PE firm and its investors can put in a comparatively small amount of cash, magnifying gains if they sell at a profit.

2. Second, it's a hands-on investment. PE firms overhaul how a business is managed. Over the years, firms say they've shifted from brute-force cost-cutting and layoffs to McKinsey-style operational consulting and reorganization, with the aim of leaving companies better off than they found them. "When you grow businesses, you typically need more people," said Blackstone Group Inc.'s Stephen Schwarzman at the Bloomberg Global Business Forum in September. Still, the business model has put PE at the forefront of the financialization of the economy—any business it touches is under pressure to realize value for far-

business it touches is under pressure to realize value for far-flung investors. Quickly.

3. Finally, the fees are huge. Conventional money managers are lucky if they can get investors to pay them 1% of their assets a year. The traditional PE structure is “2 and 20”—a 2% annual fee, plus 20% of profits above a certain level. The 20 part, known as carried interest, is especially lucrative because it gets favorable tax treatment. *–J.K.*



Familiar companies that went private in the buyout wave. *Photos: Getty Images*

The Returns Are Spectacular. But There Are Catches

For investors the draw of private equity is simple: Over the 25 years ended in March, PE funds returned more than 13% annualized, compared with about 9% for an equivalent investment in the S&P 500, according to an index created by investment firm Cambridge Associates LLC. Private equity fans say the funds can find value you can’t get in public markets, in part because private managers have more leeway to overhaul undervalued companies. “You cannot make transformational changes in a public company today,” said Neuberger Berman Group LLC managing director Tony Tutrone in a recent interview on Bloomberg TV. Big institutional investors such as pensions and university endowments also see a diversification benefit: PE funds don’t move in lockstep with broader markets.

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But some say investors need to be more skeptical. “We have seen a number of proposals from private equity funds where the returns are really not calculated in a manner that I would regard as honest,” said billionaire investor Warren Buffett at Berkshire Hathaway Inc.’s annual meeting earlier this year. There are three main concerns.

• The value of private investments is hard to measure

Because private company shares aren’t being constantly bought and sold, you can’t look up their price by typing in a stock ticker. So private funds have some flexibility in valuing their holdings. Andrea Auerbach, Cambridge’s head of global private investments, says a measure that PE firms often use to assess a company’s performance–earnings before interest, taxes, depreciation, and amortization, or Ebitda–is often overstated using various adjustments. “It’s not an honest number anymore,” she says. Ultimately, though, there’s a limit to how much these valuations can inflate a PE fund’s returns. When the fund sells the investment, its true value is exactly whatever buyers are willing to pay.

Another concern is that the lack of trading in private investments may mask a fund’s volatility, giving the appearance of smoother returns over time and the illusion that illiquid assets are less risky, according to a 2019 report by asset manager AQR Capital Management, which runs funds that compete with private equity.

• Returns can be gamed

Private equity funds don't immediately take all the money their clients have committed. Instead, they wait until they find an attractive investment. The internal rate of return is calculated from the time the investor money comes in. The shorter the period the investor capital is put to work, the higher the annualized rate of return. That opens up a chance to juice the figures. Funds can borrow money to make the initial investment and ask for the clients' money a bit later, making it look as if they produced profits at a faster rate. "Over the last several years, more private equity funds have pursued this as a way to ensure their returns keep up with the Joneses," Auerbach says. The American Investment Council, the trade group for PE, says short-term borrowing allows fund managers to react quickly to opportunities and sophisticated investors to use a variety of measures besides internal rate of return to evaluate PE performance.

• The best returns might be in the rearview mirror

Two decades ago an investor could pick a private equity fund at random and have a better than 75% chance of beating the stock market, according to a report by financial data company PitchBook. Since 2006 those odds have dropped to worse than a coin flip. "Not only are fewer managers beating the market but their level of outperformance has shrunk, too," the report says.

One likely reason will be familiar to investors in mutual funds and hedge funds. When strategies succeed, more people pile in—and it gets harder and harder to find the kinds of bargains that fueled the early gains. There are now 8,000-plus PE-backed companies, almost double the number of their publicly listed counterparts. The PE playbook informs activist hedge funds and has been mimicked by pensions and sovereign funds. Some of PE's secret sauce has been shared liberally in business school seminars and management books.

A deeper problem could be that the first generation of buyout managers wrung out the easiest profits. PE thinking pervades the corporate suite—few chief executive officers are now sitting around waiting for PE managers to tell them to sell underperforming divisions and cut costs. Auerbach says there are still good PE managers out there and all these changes have "forced evolution and innovation." But it's possible that a cosmic alignment of lax corporate management, cheap debt, and desperate-for-yield pensions created a moment that won't be repeated soon. —*Hema Parmar and Jason Kelly*

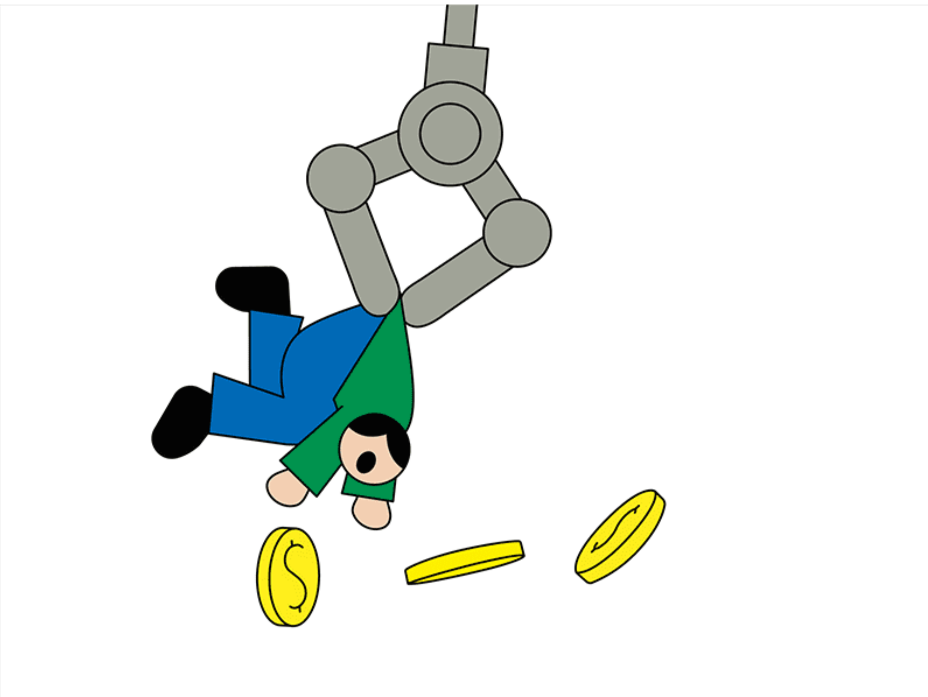

Illustration: Igor Bastidas for Bloomberg Businessweek

Buyouts Push Companies to the Limit. Or Over It

If your company finds itself part of a PE portfolio, what should you expect? Research has shown that companies acquired through leveraged buyouts (LBOs) are more likely to depress worker wages and cut investments, not to mention have a higher risk of bankruptcy. Private equity owners benefit through fees and dividends, critics say, while the company is left to grapple with often debilitating debt.

Kristi Van Beckum worked as an assistant manager for Shopko Stores Inc. in Wisconsin when the chain of rural department stores was bought by PE firm Sun Capital Partners Inc. in a 2005 LBO. "When they took over, our payroll got drastically cut, our retirement plan got cut, and we saw a lot of turnover among executives," she says.

One of Sun Capital's first moves as owner was to monetize Shopko's most valuable asset, its real estate, by selling it for about $800 million and leasing back the space to its stores. That generated a short-term windfall but added to Shopko's long-term rent costs. "A lot of stores that were once profitable started to show lower profits because they had to start paying rent," Van Beckum says.

In 2019, Shopko said it could no longer service its debt and filed for bankruptcy, ultimately shuttering all of its more than 360 stores. Van Beckum was asked to stay on as a manager during her store's liquidation and was promised severance and a closing bonus in return, she says. Weeks later, she received an email telling her that her severance claim wouldn't be paid. Sun Capital has said money has been contributed to the bankruptcy plan that can pay such claims.

Private equity and hedge funds gained control of more than 80 retailers in the past decade, according to a July report by a group of progressive organizations including Americans for Financial Reform and United for Respect. And PE-owned merchants account for most of the biggest recent retail bankruptcies, including those of Gymboree, Payless, and Shopko in the past year alone. Those bankruptcies wiped out 1.3 million jobs—including positions at retailers and related jobs, such as at vendors—according to the report, which estimates that "Wall Street firms have destroyed eight times as many retail jobs as they have created in the past decade."

Whether LBOs perform poorly because of debt, business strategy, or competition from Amazon.com Inc., research shows they fare worse than their public counterparts. A July paper by Brian Ayash and Mahdi Rastad of California Polytechnic State University examined almost 500 companies taken private from 1980 to 2006. It followed both the LBOs and a similar number of companies that stayed public for a period of 10 years. They found about 20% of the PE-owned companies filed for bankruptcy—10 times the rate of those that stayed public. Pile on debt, and employees lose, Ayash says. "The community loses. The government loses because it has to support the employees." Who wins? "The funds do."

Research by Eileen Appelbaum, co-director of the Center for Economic and Policy Research, says the problem isn't leverage per se but too much of it. She points to guidance issued by the Federal Deposit Insurance Corp. in 2013 saying debt levels of more than six times earnings before interest, taxes, depreciation, and amortization, or Ebitda, "raises concerns for most industries." A 2019 McKinsey report shows that median debt in private equity deals last year was just under the six times Ebitda threshold at 5.5, up from five in 2016.

Of course, by the time private equity acquires some of these companies, they're already in deep trouble. Defenders say PE fills a crucial role in the market. The firms have the resources and expertise to turn companies around and an incentive to invest in them to make sure there's a healthy gain when they sell or take them public, says Derek Pitts, head of restructuring at investment bank PJ Solomon. "You have to make investments to grow a smaller company," he have to make investments to grow a smaller company," he says, and some require the kind of check that only a major PE shop can write. Being shielded from the quarter-by-quarter glare of public reporting requirements may allow PE companies to experiment and focus on more than short-term results.

The retail industry was long a prime target for buyouts because of its reliable cash flow and the value of the real estate it owned. But the sector is no longer as suited to PE ownership amid ever-changing customer whims and the massive upheaval brought by Amazon, says Perry Mandarino, head of restructuring and co-head of investment banking at B. Riley FBR. "Private equity has successfully preserved companies across a number of sectors," he says, "but the disruption in retail has proven difficult for even some of the most savvy investors to navigate. High leverage, especially in this difficult environment, can be fatal."

The most notable recent example of that is Toys "R" Us Inc. When the children's toy retailer filed for bankruptcy in 2017, it was paying almost $500 million a year to service the debt from its 2005 takeover by Bain Capital LP, Vornado Realty Trust, and Kohlberg Kravis Roberts & Co. After it was liquidated in March following poor holiday season sales, its owners became the target of protests by laid-off workers, as well as scrutiny from investors and criticism from elected officials. Later that year, KKR and Bain said they'd each contribute $10 million to a fund for workers who lost their jobs when the retailer collapsed. Senator Elizabeth Warren (D-Mass.) introduced a bill in July that would limit payouts private equity owners could receive from troubled companies.

That kind of impact isn't unique to retail, says Heather Slavkin Corzo, senior fellow at Americans for Financial Reform and director of capital market policies at the union federation AFL-CIO. "The massive growth of private equity over the past decade means that this industry's influence, economic and political, has mushroomed," she says. "It's hardly an exaggeration to say that we are all stakeholders in private equity these days, one way or another." *–Lauren Coleman-Lochner and Eliza Ronalds-Hannon*

After the Crisis, Rental Homes Became an Asset Class

Renting out houses used to be a relatively small-time business. Now rentals are what Wall Street calls an asset class—another investment like stocks or timberland, with tenants' monthly checks showing up as yield in someone's portfolio. About 1 million people may now live in homes owned by large landlords. This tectonic shift can be traced to the U.S. housing crisis.

Private equity companies including Blackstone Group Inc. had the money to gorge on foreclosed houses in the years after the crash and quickly applied their model to a whole new business. They used economies of scale, cost-cutting, and leverage to maximize profits on undervalued assets. The key was to create a standardized way to manage single-family homes, scattered from Atlanta to Las Vegas, almost as efficiently as apartment buildings. PE-backed landlords set up centralized 24/7 customer service centers and automated systems for rent collection and maintenance calls.

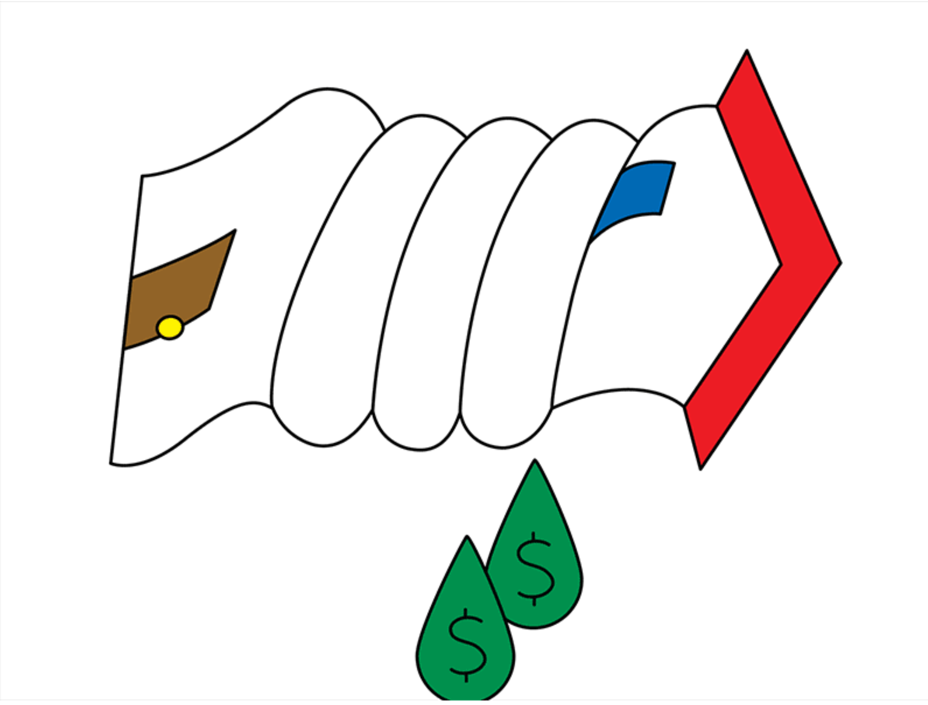

Illustration: Igor Bastidas for Bloomberg Businessweek

Blackstone-backed rental company Invitation Homes Inc. eventually went public, then merged with a landlord seeded by Starwood Capital Group and Colony Capital Inc. to create the U.S.'s largest single-family rental company, with more the U.S.'s largest single-family rental company, with more than 80,000 units. Invitation Homes owns less than 1% of the single-family rental stock, says Ken Caplan, Blackstone's global co-head of real estate. "But it has raised the bar for professional service for the industry," he says.

The aims of the landlords and the needs of their tenants often diverge, says Leilani Farha, the United Nations' special rapporteur on the right to housing. Steady rent increases that make investors happy come out of tenants' paychecks, straining household finances and making it harder to save for a down payment. Meanwhile, PE-backed companies' sprawling portfolios of rental properties may limit the availability of entry-level houses that could be occupied by homeowners. Institutional landlords were 66% more likely than other operators to file eviction notices, according to Georgia Institute of Technology professor Elora Raymond, whose 2016 study of Fulton County, Ga., court records was published by the Federal Reserve Bank of Atlanta. Invitation Homes was less likely to file notices than its largest peers, according to the paper. A company spokesman says it works with tenants to avoid eviction and that its high renewal rates indicate customer satisfaction.

From Wall Street's point of view, the model has worked beautifully. Invitation Homes has convinced stock market investors that it can manage operating costs. It also bought shrewdly, swallowing up starter homes in good school districts, anticipating that tight credit and anemic construction rates would push the U.S. toward what one industry analyst dubbed a rentership society. Sure enough, U.S. homeownership is near its lowest point in more than 50 years, allowing Invitation Homes to raise rents by more than 5%, on average, when tenants renew leases.

"The single-family rental companies have a perfect recipe," says John Pawlowski, an analyst at Green Street Advisors LLC. "It's a combination of solid economic growth in these Sun Belt markets and very few options out there on the ownership front." Shares of Invitation Homes have gained almost 50% since the start of 2019. Blackstone has sold more than $4 billion in shares of it this year. Its remaining stake is worth about $1.7 billion. *–Prashant Gopal and Patrick Clark*

Photo: Getty Images

As Profits Grow, So Does Inequality

In July, Democratic presidential candidate Elizabeth Warren of Massachusetts likened the private equity industry to vampires. She struck a nerve: Even among Wall Street companies, PE stands out as a symbol of inequality in the U.S. "There's this concentration of extreme wealth, and private equity is a huge part of that story," says Charlie Eaton, an assistant professor of sociology at the University of California at Merced.

Income gains for the top 1% in the U.S. have been rising at a faster clip than for lower groups since 1980. Since that time, PE managers have steadily taken up a larger share of the highest income groups, including the richest 400 people, according to several research papers from the University of Chicago's Steven Kaplan and Stanford's Joshua Rauh. There are more private equity managers who make at least $100 million annually than investment bankers, top financial executives, and professional athletes combined, they found. The very structure of PE firms is particularly profitable for managers at the top; not only do they earn annual management fees, but they also get a cut of any profits.

Beyond that, PE may contribute to inequality in several ways. First, it offers investors higher returns than those available in public stocks and bonds markets. Yet, to enjoy those returns, it helps to already be rich. Private equity funds are open solely to "qualified" (read: high-net-worth) individual investors and to institutions such as endowments. Only some workers get indirect exposure via pension funds.

Second, PE puts pressure on the lower end of the wealth divide. Companies can be broken up, merged, or generally restructured to increase efficiency and productivity, which inevitably means job cuts. The result is that PE accelerates job polarization, or the growth of jobs at the highest and lowest skill and wage level while the middle erodes, according to research from economists Martin Olsson and Joacim Tag.

The imperative to make highly leveraged deals pay off may also encourage more predatory business practices. A study co-authored by UC Merced's Eaton, for example, found that buyouts of private colleges lead to higher tuition, student debt, and law enforcement action for fraud, as well as lower graduation rates, loan-repayment rates, and graduate earnings. But the deals did increase profits.

Supporters of PE firms argue that they're creating value. A 2011 research paper shows that overall job dislocation over time isn't so bad. After a leveraged buyout, companies lost, on net, less than 1% of total positions, because layoffs are largely balanced by new hires, with the effects concentrated in retail and service sectors, according to the paper, co-authored by the University of Chicago's Steven Davis. He and others argue that private equity owners can turn underperforming companies into thriving businesses that attract jobs, return more money to shareholders, and bolster new technology.

Critics and advocates of PE generally agree on at least one thing: When people are hurt by deals that turn companies upside down, there should be systems in place to assist them. "You don't want to stand in the way of economic innovation," says Gregory Brown, a finance professor at UNC Kenan-Flagler Business School. "But you would hope that people who get run over are helped." *–Katia Dmitrieva*

Photos: Getty Images

Barbarians at the Gate Become the New Establishment

1970s

The U.S. Department of Labor relaxes regulations to allow pension funds to hold riskier investments. This opens up a new pool of money for buyout artists. Cousins Henry Kravis and George Roberts leave Bear Stearns with their mentor Jerome Kohlberg to form Kohlberg Kravis Roberts & Co.

1980s

L.A. financier Michael Milken (above, second from left) turns junk bonds into a hot investment, which makes getting leverage easier. Former Lehman Brothers partners Pete Peterson and Stephen Schwarzman found Blackstone Group. KKR takes control of RJR Nabisco in a stunning $24 billion deal.

1990s

Milken goes to jail for securities violations, and his firm, Drexel Burnham Lambert, collapses. But takeover artists are finding more tools for financing deals, as banker Jimmy Lee (pictured, third from left) popularizes leveraged loans at what's now JPMorgan Chase & Co.

2000s

Pensions for California state employees and Middle East sovereign funds pour money into record-setting funds that routinely surpass $15 billion apiece. Big deals of the era include Dollar General Corp. and Hilton Hotels. Several private equity firms themselves go public.

2010s

After the financial crisis, Blackstone, Ares Capital, and Apollo Global expand their private credit businesses, providing financing to companies no longer served by big banks. Veteran PE executive Mitt Romney is the 2012 Republican presidential nominee. *–J.K.*

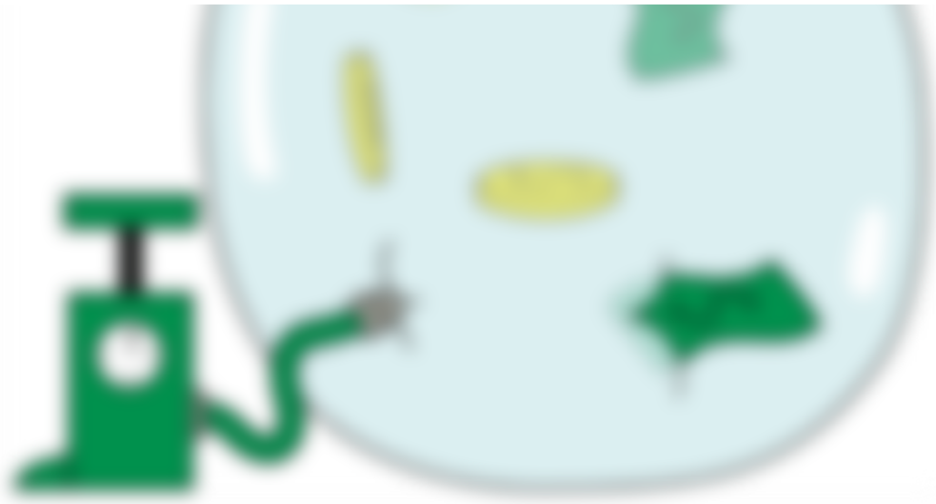

Illustration: Igor Bastidas for Bloomberg Businessweek

Private Equity Is Getting Companies Hooked on Debt

Private equity couldn't exist without debt. It's the jet fuel that makes a corporate acquisition so lucrative for a turnaround investor. The more debt you can raise against a target company, the less cash you need to pay for it, and the higher your return on that cash once you sell.

Ultralow interest rates have made this fuel especially potent and easy to obtain. The market for leveraged loans—industry jargon for loans made to companies with less-than-stellar credit—has doubled in the past decade. Almost 40% of all such loans outstanding are to companies controlled by private equity, according to data from Dealogic.

Some leveraged loans are arranged by banks. But there's also been a boom in private lenders, who may be willing to provide financing when banks or public debt markets won't. All the while, bond and loan investors desperate for yield have accepted higher risks. As buyout titans have chased bigger and riskier deals, their target companies have been left with more fragile balance sheets, which gives management less room for error. This could set the stage for a rude awakening during the next recession.

"We're seeing scary levels of leverage," says Dan Zwirn, chief investment officer of alternative asset manager Arena Investors. "Private equity sponsors are all slamming against each other to get deals done." Loans to companies with each other to get deals done." Loans to companies with especially high debt loads now exceed peaks in 2007 and 2014, according to the U.S. Federal Reserve. And companies owned by private equity typically carry a higher debt load relative to their earnings and offer less transparency on their financial position than other corporate borrowers.

Debt usually comes with rules, embedded deep in loan and bond documents, that help lenders protect their investment. For example, they might restrict dividend distributions or asset sales. The strictness of such protections has been on a steady decline over the past few years, with PE-backed companies typically offering weaker safeguards compared with borrowers that aren't backed by private equity, according to scores developed by Covenant Review, a research firm that analyzes debt documents. "Investor protections used to be written on cocktail napkins a year ago," says John McClain, a portfolio manager at Diamond Hill Capital Management who invests in junk bonds. "Now they're scribbled in crayon on toilet paper."

Buyout firms have also come under fire for massaging financial projections presented to investors when new debt is sold to make earnings look bigger and a company's debt load more manageable.

PE firms can use some of the companies they own as virtual ATMs—having the company borrow money to pay its owner special dividends. That allows the funds to recover their investment sooner than they typically would through a sale or an initial public offering. Sycamore Partners LLC, known for its aggressive bets in the retail industry and related run-ins with creditors, has already recovered about 80% of the money it put down to acquire Staples Inc. in 2017 through dividends mostly funded by debt. Carlyle Group, Hellman & Friedman, and Silver Lake have also saddled their portfolio companies with new debt to extract dividends this year. Representatives for the four private equity firms declined to comment.

Little bubbles have already started to pop, giving debt investors a glimpse of how quickly things can deteriorate. Bonds issued last year to finance Kohlberg Kravis Roberts & Co.'s deal to take private Envision Healthcare, a hospital staffing company, have already lost almost half their face value after initiatives in Washington to stop surprise medical bills spooked investors. (A representative for KKR declined to comment.) The debt of some other private equity-owned companies, including the largest Pizza Hut franchisee in the world and a phone recycling company, has also fallen in market value in recent months. "When you have people desperate for yield, buying lower-rated, poor-quality debt, the question is what's going to make this stuff blow out," says Zwirn. "And it will." *–Davide Scigliuzzo, Kelsey Butler, and Sally Bakewell*

Read more: Where Are All the Women in Private Equity? and Private Equity Flexes Muscle in Washington as Warren Picks Fight

(Corrects the 24th paragraph to cite the median debt-to-Ebitda for recent deals, rather than valuation-to-Ebitda. A previous update, in the 27th paragraph, included that KKR and Bain said they would contribute to a fund for former Toys "R" Us workers)

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