Another View: Private Equity Creates Value

By BRONWYN BAILEY

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A recent Deal Professor column by Steven M. Davidoff tries to set aside the political rhetoric and take a sober account of the private equity industry based on “the best available research.” The column focused on a number of academic studies that provide empirical support that private equity-backed companies historically show lower default rates and little difference in employment trends relative to their peer companies. Additional studies support these findings, and I agree with these claims.

The column also summarizes several other studies that demonstrate the value created by private equity’s ability to better align the interests of owners and managers – namely, more efficient use of capital and better corporate governance.

Despite all of this research, Mr. Davidoff was unwilling to draw a final conclusion about the industry, saying that “value creation has yet to be established” by empirical research.

Thankfully, there are additional studies on private equity by preeminent academics that I believe fit into the “best available research” rubric, the findings of which should allow Mr. Davidoff and others to draw a definitive conclusion about the industry’s ability to create value at the companies in which it invests.

Here are the findings of just a few:

Jerry Cao of the Singapore Management University and Josh Lerner of the Harvard Business School found that private equity-backed companies that went public consistently performed as well as or better than other comparable initial public offerings and the stock market as a whole. The accounting firm Ernst & Young found consistently in its recurring studies of the industry that private equity-backed companies in the United States and Europe outperformed their peers in growth of profit, employment and productivity.

The value created at these companies spills over to their respective industries. Shai Bernstein (Harvard Business School), Josh Lerner (Harvard Business School), Morten Sorensen (Columbia Business School) and Per Strömberg (Stockholm School of Economics)
found that industries where private equity funds had invested grew more quickly in terms of productivity and employment than industries that lacked private equity investment. Even the study from Andrew Metrick and Ayako Yasuda cited in Mr. Davidoff’s article asserted that buyouts were a “high value add industry.”

Building better companies with investment dollars results in delivering high financial returns to investors, namely pension plans, charitable foundations and educational endowments. Robert S. Harris (University of Virginia), Tim Jenkinson (University of Oxford) and Steven N. Kaplan (University of Chicago) concluded in their study of more than three decades of buyouts in the United States that net of fees, every dollar invested in private equity delivered at least 20 percent more than $1 invested in the Standard & Poor’s 500-stock index, as recently summarized by Professor Kaplan. Based only on calculations of the study’s sample of funds, “the outperformance works out to more than $120 billion in additional value” to programs financing retirement plans, charitable causes and educational scholarships. Cambridge Associates, an investment adviser and leading benchmark provider, found in its latest review of 905 private equity funds that these funds provided an 11.55 percent annual return net of fees over the last 10-year period, whereas the S.&P. 500 returned only 2.82 percent.

Contrary to Mr. Davidoff’s assertion, the body of research exploring private equity is quite extensive. It’s also quite conclusive in finding that private equity creates value in companies and delivers superior returns to its investors.