Private Equity *and Purpose*

How and when Private Equity leans into purpose

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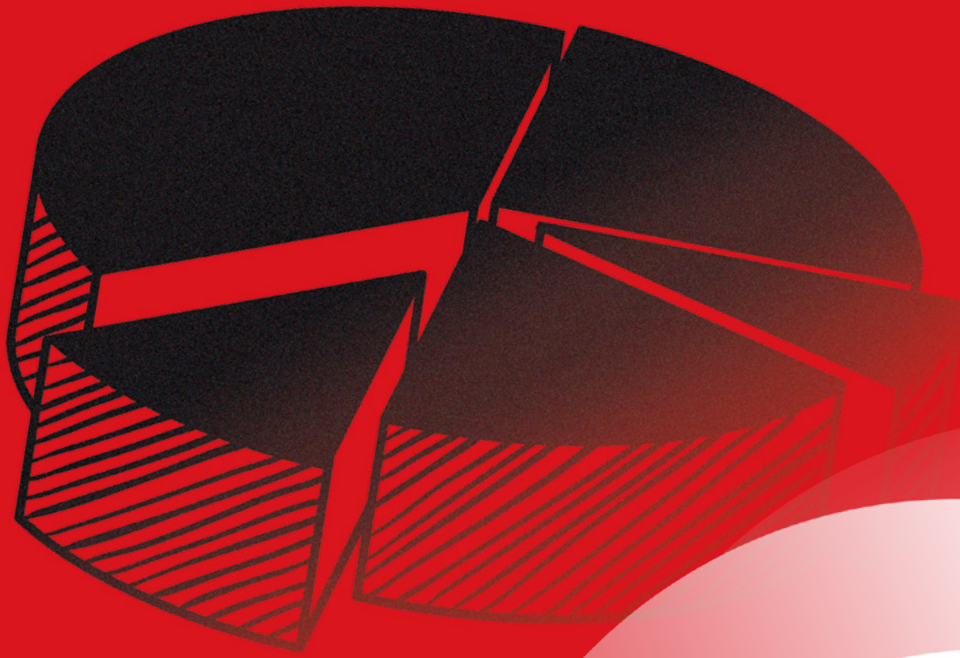

THE PURPOSEFUL COMPANY

The Purposeful Company was launched in 2015. A consortium of leading FTSE companies, investment houses, business schools, business consultancy firms and policy makers, it has been examining how the governance and capital markets environment in the UK could be enhanced to support the development of value generating companies, acting with purpose to the long-term benefit of all stakeholders.

The Steering Group, co-chaired by Clare Chapman and Will Hutton, oversees its work. Members of the Steering Group act in their personal capacity, and their views may not be taken to represent the views of their organisation. Equally the conclusions and recommendations that the Steering Group draws from its work, this report included, are ours and not every specific proposal or comment should be taken to represent the views of each of our interviewees or our task force members, although they do support our overarching principles and aims.

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Executive Summary

Private equity, intangibles and the rise of active management

- Private equity (PE) has dramatically increased its footprint on Western economies, including Britain. **In just two decades, the industry has grown from $650 billion in assets under management (AUM) to £6.3 trillion.** Supporters see it as a valuable source of economic dynamism, bringing focus and energy to the companies it acquires which would be unavailable in public markets and offering superior performance. Critics see it as a new form of raw capitalism, secretive and free to put the quest for short-term profit above any other consideration, saddling acquisitions with debt and cutting investment while extracting maximum fees and dividends along the way.
- Given the scale and growth of the industry, now challenging the primacy of the public markets, it is important to identify the conditions and circumstances where PE works well and where it works less well. This paper, focusing on buyouts that are the largest segment of private markets by AUM and concluding with a typology where PE does and increasingly will lean into purpose as a business driver, is an attempt to do just that.
- The stakes have been further raised by the opportunities that the UK market offers investors – thanks to depressed valuations of public companies, a sharp fall in the value of the pound since 2016 and the country's liberal attitude towards takeovers that makes it an easy place to buy and restructure companies.
- Classic accounts of private equity have their roots in academic theorising in the 1970s and 1980s. Due to gaps in the market for corporate control and obstacles in monitoring by dispersed shareholders, mature companies with stable cash flows and few profitable investment opportunities may indulge in value-destroying pet projects. Buyouts are one means to mitigate these problems. In this account, debt provides not only a financial boost to returns via leverage but it also helps discipline management by reducing free cash flow.
- However, the empirical evidence supporting this theory is mixed. The preoccupation with minimising agency costs between insiders and shareholders fails to do full justice to the importance of information in theories of the firm. In today's more knowledge driven economies, where the management of so called intangible assets such as Research and Development (R&D), software, data design, branding, training, business processes and the strength of stakeholder relationships have become a key driver in most business models, there is a new premium on the ability to process complex, embedded and long-term information.
- **Importantly, this provides a justification for the advantages of PE ownership. As a highly concentrated form of ownership with higher-powered incentives, it offers a framework with which investors can get into the heart of a company, examining crucial dimensions of performance and purpose** – for example, why an R&D project has failed or if diversity and inclusion programmes go beyond box-ticking. Combined with a lack of public stock prices and extended holding periods, investors can take strategic decisions free of quarterly reporting pressures. As PE shares necessarily are privately held and lack liquidity, investors have an incentive to provide strong returns over the long term which they can only unlock after investments are exited rather than temporary uplifts in the stock price.

- By taking outright ownership and control of a business, PE can radically direct which opportunities a company will pursue and in turn shape its strategy, operations and even culture. **If purpose is valuable, PE will not neglect it for long.** This element of control is especially attractive at a time when there is growing frustration with the quality of insight and data provided by third parties and a growing recognition that direct investor engagement makes good business sense both in delivering returns and ensuring that investor priorities, including purpose and ESG, are properly heeded.
- It is important to strike a cautionary note. Private equity remains an expression of the shareholder value ownership model and therefore embodies the same strengths and weaknesses as critics level against its operation in the public markets. PE takes it to more extremes. But it does avoid some of the incentive problems and monitoring costs evident in more distant and fragmented shareholder relationships.
- **There are signs that private equity investors are getting more hands on with portfolio companies.** Necessity as much as choice has guided this behaviour: as the success of private equity has attracted more capital to the industry and spurred many imitators, so competition for a limited pool of assets has increased, pushing up purchase price multiples. Buying at premium prices makes it ever more difficult to create value during ownership and exit, forcing firms to take a much wider view of value creation than in the past to produce an acceptable return for investors. In this context there may be more opportunity for purpose to be deployed as a value driver.
- **However, truly active management is not the common rule, even if more are taking note of its potential.** Practitioners observe that few PE firms truly qualify as 'active performance partners'. For their part, only a small number of PE firms believe they have reached the full potential on their investments most of the time. Private equity is also discovering that it is not exempt from the rules of the road that apply to other organisational transformations. Resource constraints, data fragmentation, economies of specialisation, minimum holding periods, low levels of trust and diminishing returns all pose barriers to successful execution of value creation plans. It may explain why investors are increasingly looking for types of specialisation that may or may not be offered by classic buyout funds and is consistent with evidence that PE with investments in a single industry often perform better than generalists.

Beyond one-size-fits-all: *understanding the heterogeneity of buyouts*

- **PE is not a homogeneous universe.** This can be seen in the wide dispersion of returns, long a defining feature of the asset class and one that contrasts strikingly with public equity and fixed income markets.
- **The economic effects of PE vary** by (i) buyout type (ii) macroeconomic and credit conditions and (iii) sponsor characteristics.

  i. ***Buyout type:*** Productivity gains and growth appear more predominant in private-to-private transactions than public-to-private transactions. This could reflect the fact that private equity brings different advantages to a private-to-private buyout, including access to capital and management skills. Private-to-private deals are also typically less leveraged and less likely to encounter financial distress. These differences and their implications are sometimes obscured by high profile transactions when well known public companies are taken private – even though they constitute only a small share of PE activity in volume terms.

  ii. ***Macroeconomic and credit conditions:*** there is a growing understanding that the choice of value creation strategies is highly cyclical. When credit is cheap and readily available, PE firms focus on delivering returns via financial engineering such as issuing new debt to fund additional dividend payments to equity holders and exploiting the spread between cheap borrowing costs and the returns earned by portfolio companies. By contrast, deteriorating economic or tightening credit conditions make financial engineering less viable, compelling PE firms to emphasise operational improvements to create value, thereby 'growing the pie'. This is consistent with observed productivity differences across buyouts executed at different stages of the economic cycle.

- This raises distributional questions about the trajectory of recent PE activity. Economic conditions of the last few decades have underwritten a long ascent in the majority of asset prices. In the wake of the financial crisis of 2008, central bank intervention put a floor on downside risk for investors, keeping markets not only liquid but prospering. Against this backdrop, a rising tide has lifted all boats. There is evidence that 'multiple expansion' – or selling a company at a higher multiple of its earnings than it was purchased for – has overshadowed margin and revenue growth as a driver of returns in the second half of the decade, meaning that PE investors have been able to buy portfolio companies and realise an increase in value in the absence of operational improvements. Indeed, the average PE fund appears to have become less successful at improving the performance of its portfolio companies. Other empirical clues supporting the multiple expansion theory are falling average holding periods and growth in the secondary space where a significant number of transactions involve the sale of companies between PE funds that are largely similar in skillset.
- The main exception to all this is the software and technology sector, where organic drivers have made a more balanced contribution to returns.

  iii. ***Sponsor characteristics:*** PE groups have a distinctive investment style that is sticky over time and influences how they approach value creation at target firms. In particular the career background of founding general partners appears to leave a lasting impression on the strategies of PE firms. This suggests that PE firms cannot readily shake off the past to reinvent themselves. Equally once gained, a reputation for purpose or ESG is likely to be credible, assuring LP investors that this information can be used to guide manager selection decisions.

- **Fund size also matters.** The evidence is that rapid upscaling in deal flow at the PE group and fund level is associated with inferior outcomes for investors and stakeholders at large. This may reflect that it is harder for GPs to keep an eye on deals, manage workloads and ensure consistent quality standards. Another possibility is that the increasing scope of funds' portfolios induced by scale leads managers to include companies in more industries and not stick to what they know. Complementary work also points to the tendency for incentives to become less aligned as PE sponsors grow in size. These risks appear greater for publicly listed PE firms that must now serve two masters – public shareholders and LPs whose interests are not necessarily aligned.
- These concerns are not new but they have taken on more urgency with the growth of mega-funds: in 2021, the largest PE funds – those with assets under management greater than $5bn – attracted nearly half of all buyout capital raised. Investors appear undaunted to date, pointing to the narrower dispersion of returns for mega-funds than smaller funds, seemingly making them a safer bet for investors concerned about downside risk – along with the range of services that the largest managers provide, including risk management, access to co-investment opportunities and other asset classes and sound ESG policies.

Leverage, *risk and purpose*

- The most controversial and least understood aspect of PE is the way it uses higher debt levels than most other companies. Much of the criticism directed at PE owners revolves around the claim that leverage increases the risk of bankruptcy or cut backs on areas of expenditure, that while important in the long term, appear discretionary in the short term. It may also lead parties to base financing decisions on tax and cost avoidance considerations with consequences for the provision of public goods, given most countries' tax systems favour debt over equity, allowing debt interest payments, but not the cost of equity, to be treated as a tax-deductible expense. This can have negative impacts on employees, lenders, consumers and taxpayers.
- However, this commonly held view is not representative of all experience under PE ownership. One possibility is that PE owned companies are inherently less risky with more predictable revenues and are therefore capable of bearing greater leverage. However, support for this claim is mixed: evidence suggests that firm characteristics matter but that, in many cases, the extent of leverage in buyouts is driven more by interest rates and general credit conditions with PE firms leveraging up as much as possible when credit is cheap and plentiful.
- A more persuasive claim is that PE firms in general are more skilled at managing the effects of leverage than other investors. There is evidence that although PE firms may be more highly leveraged, controlling for leverage, they are no more likely to default. Indeed when they do default, they restructure more rapidly and frequently out of court and are more likely to survive as an independent going concern. Leveraged buyouts also have significantly weaker loan agreements via deductibles and carve-outs that help shield financial sponsors from financial distress, but may also impose hidden costs on creditors.

- Studies thus paint a relatively sanguine picture of the costs of leverage in PE for financial stability. For example, during the Global Financial Crisis, PE owned companies decreased investments less and had higher growth than their peers. This result is explained by the ability of PE owned businesses to draw on the resources and relationships of their sponsors to raise equity and debt during this challenging period. So, far from being an albatross around the necks of PE funds, dry powder – capital raised but not yet invested – became a critical source of liquidity to assist portfolio companies.
- Nonetheless, the differences between today's conditions and 2008 are notable. First, the 2008 crisis was marked by a swift V-shaped rebound with indicators of financial health such as high yield credit spreads returning to pre-crisis levels within less than 10 months. It is not inconceivable that a more protracted economic downturn would place more acute strains on portfolio companies. Indeed, investors have been confronting conditions unfamiliar to many – the fastest and most aggressive interest rate hike cycle in more than three decades amid inflationary pressures. The next downturn, once it comes, may be one in which central banks struggle to ride to the rescue as they have done during previous bear markets. Second debt loads in the US buyout market – as measured by debt to EBITDA – are at their highest level in recent decades.
- Indeed, actual leverage at a fund and portfolio company level may be understated by the extensive adoption of subscription lines and EBITDA adjustments – under which lenders have increasingly permitted PE firms to calculate multiples based on projected earnings rather than actual results. Such calculations tend to bake in expectations for cost cutting, synergies and revenue increases regardless of whether they are achieved. The majority of addbacks in recent years have come from projected cost savings that could be harder to achieve if inflation turns out to be more persistent.

Private equity's approach to purpose *and enlightened shareholder value*

- **Historically, PE has been slower to embrace ESG than public companies** that are subject to more regular and extensive reporting requirements and have greater experience in managing a wide set of stakeholders.
- The pace of change can nonetheless make assessment look out of date very quickly. A small but growing number of PE firms are becoming more sophisticated in their approach to ESG. What was once a peripheral exercise in compliance or a niche product for a small minority of investors is now seen as a source of competitive advantage, informing each stage of the investment process, including post exit analysis. This is supported by industry-wide efforts by GPs and LPs to standardise the industry's fragmented approach to ESG data collection and reporting and provide a common basis on which to assess and compare the performance of portfolio companies.
- Despite the growing influence of ESG, it is not yet considered one of the top five levers for value creation as compared with strategies like buy and build – a situation that is unlikely to change in the next few years.

- However, we may be looking in the wrong place if we simply equate 'doing well by doing good' with a stated commitment to ESG. If commitments to ESG and purpose help drive value, PE will likely opt in as a matter of enlightened self-interest. Thus, a number of studies find that stakeholder outcomes from workplace safety to investment in employee IT skills to restaurant hygiene improve under PE ownership. In each case, a win-win solution is possible: workplace safety simultaneously benefits workers and is a source of value for investors through decreased downtime, fewer lawsuits, lower compensating wage differentials, increased employee morale and productivity and improved chances of an IPO exit. Another common thread running through these cases is that they involve well-oiled reflexes: activities can be broken down into tangible, value-driven use cases and are relatively low cost. Thus, in the case of workplace safety, improvements are linked to changes such as setting targets, introducing scorecards and strengthening monitoring that are already part of the PE operational toolkit.
- **PE firms are quick to adopt strategies that work.** As a case in point, major PE firms have begun to broaden employee ownership beyond senior executives to cover all workers in portfolio companies. Initiatives to strengthen employee engagement and loyalty – the 'S' in ESG – are particularly appealing at a time of tightening labour markets when rising input costs, including employee turnover, have emerged as key risks to corporate margins. Of course, the same logic implies that PE investors are unlikely to stray too far from their comfort zone or basic operating assumptions. Thus, profit-sharing initiatives may be significant relative to the industry's past record. Measured by ambition, however, they are relatively modest compared to the goals of the broader employee ownership movement.
- The gains from purpose, such as high employee satisfaction and improved retention, are softer and harder to link to profit maximisation – and may be underweighted in corporate decision-making relative to nearer, more measurable goals. This can be seen in the impact of PE ownership on dimensions of job quality such as compensation, work-life balance, culture and relations with senior management as well as broader measures of organisational purpose. All typically fall after a buyout, albeit with significant differences across buyout type and job grade.
- **There are nonetheless fundamental limits to enlightened self-interest as a basis for purpose.** Even if a party acknowledges the need to invest in stakeholders, it has strong incentives to do so to the minimum extent necessary to enhance shareholder value. More starkly there is nothing in this calculus that prevents firms from taking actions that are privately profitable but socially costly even as they aim to maximise their own long-term value.

Externalities, sector considerations *and capitalism in high gear*

- **The impact of PE on society and the wider economy depends critically on sector characteristics and market structure within which PE owned companies operate.** Companies that operate in markets with high levels of competition and price elasticity of demand, minimal government subsidies and transparency around product quality tend to yield superior outcomes for stakeholders. Examples include consumer-facing sectors such as consumer staples and hospitality. In contrast, PE investment in sectors with relatively low competition, information frictions and the presence of government subsidy can reduce stakeholder welfare. Examples include health, education, defence and infrastructure.
- Looking at behaviour at the wrong granularity nonetheless can lead to mistaken diagnoses about what is going on and poorly targeted policy responses. For example, it is difficult to speak about the healthcare sector in toto; in practice it encompasses many different activities: thus, the effects of PE ownership may look quite different in dermatology or optometry where patients tend to be less vulnerable, have more choice and pay more out of pocket than, say, patients in nursing homes. Similar caveats also apply to the role of PE firms in heavily regulated and subsidised industries such as banking.
- **In practice, both the positive and negative impacts of PE may be present in a given transaction.** In journalism, for example, PE ownership has negatively resulted in a decline in local news and shift in the composition of news towards national topics with knock-on effects for civic and political engagement. But on the plus side PE has improved the survival prospects of newspapers by increasing digital subscriptions and facilitating the transition to a more resilient business model.
- The impacts of PE cannot be detached from their larger context. Consider private equity's reputation for ruthlessly laying off workers. Research shows that buyouts are often followed by a decline in employment and increased staff turnover. But in numerous cases, the buyout targets were in urgent need of restructuring and retrenchment and acting earlier saved deeper pain down the line. On occasions job losses after certain types of buyouts were crucial for realising post-buyout productivity gains that benefited society at large. A more accurate characterisation is that PE ownership accelerates and magnifies underlying market forces that are sometimes creative and other times highly disruptive. In an era of widespread anxiety about the future of employment and economic inequality, as well as anaemic productivity growth, these questions are more fundamental than implied by critics of PE and should be addressed in a more comprehensive manner.

Aligning shareholder preferences with the broader public interest: *the role of regulation and asset owners*

- **Aligning the interests of private equity with the wider economy is ultimately the domain of public policy, whatever progress might be made under the banner of privately initiated stakeholding.** The good news is that any improvements in the competitive and regulatory environment tend to be amplified under the high-powered incentives of PE ownership. Thus PE owned firms may cut emissions more aggressively when the risk of environmental liability is high or improve quality of care where regulators arm consumers with information to quickly and easily assess healthcare providers.
- **Against such promise, there are the potential costs of intervention.** Just because a problem exists does not mean that a new regulation will solve it – and even when a solution exists, enforcement bodies may simply lack the capacity to monitor and detect regulatory violations.
- Regulatory arbitrage has been a thorn in the side of regulators since time immemorial. But the stakes are higher with PE which is incentivised to hunt out every possible avenue of profit. High-powered incentives are a double-edged sword: they induce more productive effort but also more unproductive effort if regulatory goals are not set appropriately or there are weak checks on unintended consequences. It may require a regulatory response grounded in simplicity, not complexity. That is, if purpose is to have teeth, then it might be advisable to demand less of it, and to ensure that the lesser demands are enforceable.
- **The popularity of buy and build strategies has given a new twist to these questions.** There are obvious benefits to horizontal consolidation in what are often fragmented cottage industries but there are also concerns about what this means for competition and market power. This matters because the value of bolt-on acquisitions is often too small to trigger reporting requirements for antitrust review in markets like the US. There is evidence that deals are carefully structured to evade scrutiny. Not only do acquiring firms benefit from such stealth acquisitions but so do their industry rivals who are able to take advantage of softer product market competition, limit output and raise prices while reducing quality. These findings are not unique to PE ownership but they should be taken into account when assessing the impact of private equity since 'buy and build' has a similar tendency to increase market concentration in small, steady steps, posing the risk of monopoly by a thousand cuts.
- In addition to regulation, **GPs are also under increasing pressure from LPs to incorporate stakeholder considerations into their investment and portfolio construction process.** The industry is facing greater commercial competition to win mandates and, as a result, funds without regard to these issues are becoming harder to sell.
- This has been accompanied by a growing appetite for long-dated PE funds that can bear riskier product development plans and intangible investments that take longer to show results. Whether this trend gains momentum, however, remains to be seen. After all, mandatory exits provide an objective and unambiguous yardstick of a fund's performance. Investors seeking to hold assets over a long period need a clear-headed view of the incentive and governance risks that arise from pushing the resolution of these questions further into the future.
- Progress on ESG integration varies geographically: adoption rates are higher among European asset owners (LPs) than counterparts in the US, albeit

with some exceptions. However, even among LPs that consider ESG initiatives during fund screening, significant gaps remain. The vast majority of LPs largely use ESG considerations as part of negative screening with its attendant inefficiencies. The widest adoption of ESG considerations occurs during due diligence but it is often process-oriented and backward-looking, providing little guidance to how asset managers (GPs) will address future performance or purpose risks. Once money is committed, there is a perception that LPs shift their attention to returns and take an interest in ESG and purpose only if they believe it is not hurting returns. LPs may also be reluctant to press GPs on these issues for fear of rocking the boat and getting shut out of future investment opportunities.

- One strategy to align PE and stakeholder interests is to embed ESG and purpose explicitly into governance arrangements between LPs and GPs. In particular, the world of impact investing holds out useful lessons in how the private capital model and even the asset owner-asset manager relationship more generally might be reimagined to support wider goals. What is most interesting about these arrangements is what they don't do: very few funds tie compensation to impact and most retain traditional financial incentives given uncertainty around the nature and performance outcomes of impact. This runs counter to the growing consensus that executives' compensation plans should incorporate precise ESG metrics and belief that combining strong rewards for dollars with weak rewards for impact will simply encourage agents to spend too much time on rewarded activities and not enough on other desired activities. Impact funds redress this incompleteness by granting investors far greater voice in, and oversight of, key fund decisions than has traditionally been the case in LP-GP relations. This allows LPs to implement impact goals dynamically, 'braiding' what they learn from monitoring GPs' behaviour, including the informal components of contract performance such as GPs' willingness to work towards joint goals, into the funds' operational decisions, thereby reining in the distortionary effects of rewarding only financial performance.

- **Providing effective governance to PE funds requires considerable skill and effort.** Studies underscore the difficulty of identifying top PE funds by relying only on statistical measures of performance. Rather LPs must leverage other sources of information about PE firms and their past funds, such as their internal organisation and culture, partner attributes, compensation structure, alignment of interests, deal sourcing and integration of ESG. As this information is difficult to collect and transmit, returns to LP skill appear high with evidence that some LPs are consistently outperforming competitors. This raises important questions both for LPs, particularly non-profit or public institutions that lack the resources and networks of other asset owners, to successfully access and evaluate investments, as well as rising calls to 'democratise' PE by expanding retail access to private markets where liquidity, validation and transparency issues add to the importance of manager selection.

- **Policy must adopt an ecosystem approach to purpose.** This is a challenging view for policymakers, who – from necessity and expediency – often focus on one component of capital markets in isolation and commentators who treat public and private equity as two distinct, and rival, forms of economic governance. In reality, purpose in private equity cannot flourish without healthy public markets. While privately held firms have considerable advantages when it comes to investing in ambitious and novel projects, they face a higher cost of capital that can eventually become a drag on growth. Publicly listed firms, by contrast, benefit from a lower cost of capital that is well aligned with the needs of commercialisation and profitability but they are less equipped to undertake risky investments with the highest potential payoffs. Understanding these lifecycle patterns – and the critical moments when performance and purpose needs tend to shift – can help policymakers think about how to support the ecosystem at each stage for its sustained success.

- These complementarities run deeper still. Public equity markets provide an incentive for PE firms to make operational improvements, in the hope of selling their investments through the IPO markets and exiting them at a hefty multiple. More subtly, concerns about the accountability of particular businesses or ownership models may increase generalised distrust towards markets at considerable cost to the economy and society. The logic of this mutual dependence implies that when one part of the ecosystem is weak, it is not made stronger by strengthening the other parts. Purpose is limited by the ecosystem's weakest subunit, or 'link'. Because of this dynamic, relatively small frictions can multiply up to yield large distortions. It also implies that when each part is managed independently, the ecosystem can get stuck in a suboptimal state. Some commentators identify the widening regulatory gap between public and private equity markets – reflected, among other things, in divergent transparency and disclosure requirements – as a source of potential instability.

In Conclusion

- **PE ownership is not the negative force that its critics depict:** if it did not add value in the broadest sense of the term, then from a simple Darwinist perspective, it would not have reached its current size. In many cases, PE through its close link between ownership and control has proved to be a remarkably effective vehicle for enacting positive change.
- Investing successfully in ESG and purpose takes time, effort and engagement. Discerning LPs know that investing with these criteria in mind by screening out or divesting non-compliant ESG companies is unsatisfactory, does not solve the problem and foregoes potential profitable opportunity. It denies investors the opportunity to engage with the companies that need it most or who have credible transition plans in place. The basic element of control that accompanies the private equity ownership model, in this regard, is highly appealing.
- PE is not stable, indivisible and irreducible but rather a heterogeneous universe. It is better to consider PE not as a distinct form of ownership, but rather a more extreme form of shareholder capitalism with all its strengths and weaknesses. Thus, PE ownership is unlikely to be suited to all firms at all times, making it important to understand the conditions under which private equity is more likely to create long-term value for society. The table below, setting out seven dimensions of PE ownership, attempts to do just that.
- Purpose and ESG are here to stay. Climate and demographic change are shifting behaviours and attitudes with customers and employees; LPs today are expecting much more from the companies with which they do business. This is reinforced by technology, social media and new sources of data that give far more visibility into the actions of companies, deepening accountability and raising the reputational costs of corporate misconduct. It will take a brave PE investor to bet against these trends, if only because public markets are required to care about these issues and PE still relies on public markets for successful exit.
- Although PE has grown strongly, beware the view that the public corporation is in inevitable decline. PE is strongly cyclical, having undergone periods of expansion and contraction. An era of higher interest rates and an uncertain macro backdrop will constitute a challenge for some PE firms and business models.
- The future is unknowable. But if a leaner, more consolidated industry emerges on the other side, it is also likely to be one that has acquired new skills and puts an even greater emphasis on making operational improvements to firms that make the overall economic pie larger – heeding the role of purpose and ESG – and so help realise the promise inherent in PE ownership.

Seven dimensions of purpose in private equity

Private equity buyouts have grown to the point where it is large enough to have major effects for purpose. Private equity ownership is often treated as a monolith, either praised for growing the pie and creating long-term value or criticised for supposed 'strip and flip' strategies. However, existing literature and our work reveals considerable heterogeneity in the value creation mechanisms and outcomes of buyouts which calls for a more fine-grained approach. The typology we present here is not meant to be exhaustive but rather to highlight those conditions and characteristics that occur most frequently and have the largest impact on purpose.

	Driver of purpose	Characteristic of private equity that lends itself to purpose	Notes
1	**Strategy and implementation**	As concentrated, resourced and incentivised investors, PE investors are able to get into the needs of portfolio companies, collect soft information and customise value creation plans to their unique needs. However, successful implementation is subject to resource constraints, economies of specialisation, data challenges, minimum holding periods, diminishing returns and the need to build trust with the managements of portfolio companies.	To warrant paying higher multiples, PE is under more pressure to improve operational value to produce desired returns. It explains the growing role of operating partners – the PE industry has 30% more operating resources at its disposal than it had just four years ago. But an era of true active management is some way off: survey evidence finds that only around 1 in 10 PE firms believe they have reached the full potential on their investments 90% of the time, while multiple expansion has remained the largest driver of buyout returns over the past half decade. The most successful PE funds have a clear focus that is aligned with their core competencies. The odds of successfully implementing value creation plans appear greatest for PE funds with a long track record in a sector. Focus can also be created in less obvious ways: some funds are extremely deliberate about the kind of risks they are willing to underwrite in any deal; some have a well-defined playbook to create value that works on companies with particular characteristics; and some can bring to bear significant resources to their investments.
2	**Buyout type**	Private-to-private buyouts exhibit greater operational improvements than public-to-private buyouts, as manifested in growth in profitability, employment, sales, capital expenditures and innovation. This may reflect the fact that PE brings different advantages to private-to-private buyouts, notably management skills and access to capital, enabling targets to take advantage of previously unexploited growth opportunities. Private-to-private transactions also provide greater scope for value creation and arbitrage strategies like buy and build. Finally, buyouts of privately-owned firms tend to be both less leveraged and less likely to encounter financial distress.	Evidence based on large samples and comprehensive data across different countries and time periods. Over the past decade, private firm buyouts have outnumbered buyouts of publicly-traded firms in the US by more than 30-1, although the latter account for a larger share of transactions by value and typically increase over the course of the market and credit cycle.
3	**Sector/product characteristics**	Superior stakeholder outcomes are found in sectors with high levels of competition, minimal government subsidies, high price elasticity of demand and transparency around product quality.	This is consistent with evidence for sustainable value creation in sectors such as fast-food restaurants, consumer products and big box retail stores in contrast to healthcare, education and defence where gains from buyouts have, at times, come from wealth transfers from other stakeholders. Determining the extent to which PE and stakeholder interests align is nonetheless a matter of careful, case by case analysis – for example, dermatology or optometry operate in a more transparent and competitive market.

	Driver of purpose	Characteristic of private equity that lends itself to purpose	Notes
4	**Regulatory environment**	Effective regulation by government is essential to aligning the incentives of PE and stakeholder outcomes.	PE appears more sensitive than other market participants to policy changes such as competition intensity, transparency requirements and environmental liability risks but equally more capable of exploiting regulatory loopholes. Policymakers walk a tightrope between preserving a level playing field and not creating new distortions and loopholes in the process. Buy and build transactions now make up ~70% of PE companies' deal volume, up from 40% in 2004 – but this strategy can present challenges for market concentration and competition.
5	**Macroeconomic and credit conditions**	Buyouts executed amidst tighter credit conditions are shown to grow the pie for stakeholders more than deals executed when credit is cheap and readily available. As conditions tighten, so delivering returns via financial engineering or multiple expansion becomes less viable, prompting PE firms to focus on operational improvements instead. Economic downturns can interact with high leverage and loan covenant constraints to amplify underlying vulnerabilities in portfolio companies, creating pressures on PE funds to take restrictive actions such as cutting investment and innovation.	Cheap credit, intense fundraising and competition for assets has put pressure on valuations and subsequent future returns. Multiple expansion – or exiting at a higher valuation – has been the biggest factor in generating returns for PE deals over the past decade (with software deals being the exception). Leverage ratios have also increased substantially and the increase is even more pronounced after taking into account EBITDA 'adjustments' and subscription lines, although evidence suggests that PE has differentiated skills in managing high levels of debt, particularly during economic downturns.
6	**Time horizon**	Investment in stakeholders is more likely where there is clear and obvious business logic and the timing and magnitude of the economic value created is predictable and not too distant. Interventions benefitting stakeholders typically fit within an existing playbook for creating value such as setting targets, introducing scorecards and increasing monitoring.	The role of enlightened self-interest in motivating pro-stakeholder actions reflects in part the relative immaturity of ESG investing in PE. ESG is currently ranked 13th of 15 in terms of its importance as a value creation lever and only expected to rise to 10th by 2025. Risks such as health and safety and supply chain sustainability are better understood by mainstream PE investors than employee satisfaction and corporate purpose that are softer and harder to tie to the bottom line, especially in public-to-private transactions. An open question is how perspectives on materiality that affect the risk/reward of potential investments will evolve in response to changing societal norms and expectations and advances in measurement technology.
7	**PE sponsor characteristics**	PE groups are characterised by management stability and distinct investment styles that persist over time. There appears to be a detrimental impact of increasing fund size on returns – whether due to organisational diseconomies of scale emerging from coordination difficulties, investing in unfamiliar sectors or an increased focus on collecting management fees that are less sensitive to performance. The secondary market – the buying and selling of assets before the end of a PE fund's agreed term to another PE fund – has emerged as a prominent form of exit and the respective characteristics of the buyer and seller have a strong bearing on whether secondaries create or destroy value for investors and society.	Current PE firm strategies can be linked to the background and career history of the founding general partners. This suggests that a reputation for purpose or ESG is more likely to be credible, providing reassurance to investors that this information can be used to guide portfolio decisions. The big have been getting bigger: in 2021, the largest funds (AUM> $5bn) attracted almost half of all buyout capital raised. However, the impact of fund size on performance needs to be interpreted carefully. For example, firms that grow by multiplying their number of investments may find it harder to outperform while firms with a large amount of money but few investments or firms with independent sub-teams should produce better outcomes, all else being equal. Equally many big LPs may invest in large PE funds for reasons other than top quartile performance, including ability to absorb large amounts of money, lower volatility of returns, access to co-investment opportunities and other asset classes and sound ESG policies. LPs require considerable skill and effort to identify the best managers and engage effectively on matters of performance and purpose – returns to skill are high and appear to differ systematically across LPs. Secondaries are more likely to create where buyer and seller have complementary skill sets. Examples of such complementarities include a PE fund focusing on margin growth and a PE fund focusing on sales.

> *"People generally see what they look for, and hear what they listen for"*
> **— Judge Taylor in Harper Lee's *To Kill A Mockingbird***

> *"Many who before regarded legislation on the subject as chimerical will now fancy that it is only dangerous, or perhaps not more than difficult. And so in time it will come to be looked on as among the things possible, then among the things probable; and so at last it will be ranged in the list of those few measures which the country requires as being absolutely needed. That is the way in which public opinion is made."* **— Anthony Trollope, Phineas Finn**

Once an esoteric corner of the investment world, private equity has dramatically increased its footprint on the economy. Today, private equity has a hand in many of our daily decisions by acquiring stakes in everything from utility companies to veterinary practices to sports clubs like Chelsea FC, to the music catalogues of Taylor Swift and Leonard Cohen. Investing on behalf of governments, pension funds and university endowments, they are responsible for trillions in retirement savings. In just two decades, the industry as a whole has grown from $650bn in assets under management (AUM) to $6.3tn (McKinsey, 2022).[i]

The ability to raise ever larger sums of money privately is not only challenging the primacy of public markets but is also having major consequences for purpose and the ability to produce high levels of sustainable value over time. These consequences are not just a function of size – more than 20 million employees worldwide work in companies owned by private equity firms. They also inhere in the nature of the PE business model that has an active operational component. By taking outright ownership and control of a business, private equity can radically direct which opportunities a company will pursue and in turn shape its strategy, operations and even culture. This contrasts with other financial investors who are more constrained in their ability to affect firm performance, no matter how insistently they pound on the boardroom table.

Given the dramatic transformation in the role of private equity, it is not surprising that it has attracted increasing scrutiny. The legacy of its own secretive history has made private equity an easy target for critics who accuse PE investors of putting the quest for short term profit above any other consideration, saddling acquisitions with debt and cutting investment while extracting maximum fees and dividends along the way.

These criticisms have intensified in recent years with the larger populist irruptions, on the right and left, in Europe and the US. The collapse of some of the UK's best-known retailers under PE ownership and the collateral damage for high streets, traditionally the economic and social pulse of UK towns and cities, has emerged as a particular flash point.[ii] Critics contend that while these businesses were hurt by the rise in online shopping and shifts in consumer preferences, their downfall was ultimately hastened by overburdened balance sheets and debt service payments that meant they could not invest properly in their turnaround and compete with better-funded rivals.

Not all claims are created equal and this account has not gone unchallenged. Practitioners argue that much of this talk invokes a vision of private equity with aggressive financial engineering that no longer exists. The industry has scaled back many of the practices that tarnished its reputation and increasingly relies on new sources of value creation. Indeed, they argue that private equity is uniquely suited to today's grand economic and environmental challenges thanks to its informed, patient and activist approach. This comes at a time when the limitations of divestment, exclusions and reliance on third-party metrics as an approach to ESG are coming to the surface (Berk and Van Binsbergen, 2021; Edmans et al., 2022). On this account, public companies that are conscious of their own longevity or contribution to

purpose can learn a great deal from private equity in areas such as board monitoring and performance management (Acharya et al., 2013; Gilson and Gordon, 2020).

In short, private equity buyouts function as a kind of Rorschach test with different groups seeing in it what they want to see.

The stakes of this debate have been raised by depressed valuations of public companies and a sharp fall in the value of the pound since 2016 that have fuelled a surge of interest from buyout firms flush with cash. In the words of one executive 'everything in the UK is on sale' (Wiggins and Gara, 2022). Trends have been given a helping hand by a favourable institutional environment, including a liberal attitude towards takeovers and policy interest in directing more of the nation's retirement savings into private equity and other illiquid investments. Institutional investors have continued to increase allocations to private markets as they have sought higher potential returns in a low-yield environment.

Whether the industry's growth will continue unabated as the market regime shifts from disinflation to inflation, and from negative to positive interest rates is unclear but what is clear is that the private equity industry is here to stay (Ivashina, 2022). Finally, there are political economy questions about what this redrawing of ownership boundaries means for management's accountability to the wider public given unequal disclosure requirements between private and public markets and the ability of ordinary investors to buy into these companies and share in their future success that is key to maintaining support for pro-business policies and the legitimacy of a modern market economy.

This paper considers these issues with respect to buyouts and to a lesser extent later-stage private equity investments. Given the inherent complexity of private equity, it does not attempt an exhaustive review of the role of purpose across the entire industry. Buyout funds resemble other forms of private equity in a number of respects, sharing similar legal structures, control rights, incentive arrangements and investors. But they also pose a different and quite interesting set of issues – not only in terms of the types of firms they target but also in terms of the higher levels of debt used in transactions. Buyouts are particularly topical as they are the largest segment of private markets as measured by assets under management (McKinsey, 2022). To this end, the paper brings together a substantial body of evidence to explore the relationship between PE and purpose in light of these debates. It combines the academic and practitioner literature with interviews with PE investors, ESG specialists and senior business executives to build a picture of the impact of PE investments in the broader economy.

The paper proceeds as follows:

- **Section I** explores the structural and theoretical features of private equity ownership that are conducive to purpose, particularly the role of concentrated ownership in evaluating intangible assets and driving operational improvements before considering how this works in practice.
- **Section II** discusses the fundamental heterogeneity of private equity ownership that calls for a much more fine-grained approach and begins to unpack the conditions under which it is more likely to support (or frustrate) purpose. This includes a discussion of issues such as buyout type, macroeconomic and credit conditions and sponsor characteristics.
- **Section III** – another feature of private equity ownership is that it uses higher debt levels than most other companies do and the implications are assessed in this section.
- **Section IV** turns to the role that ESG plays in private equity, charting both progress and obstacles to date and suggests that enlightened shareholder value is perhaps a better lens through which to understand behaviour.
- **Section V** builds on these insights and shows how welfare outcomes for society depend critically on the competitive and regulatory structures within which private equity owned companies operate, highlighting important sector and subsector differences.
- **Sector VI** discusses the implications for policymakers and asset owners.
- **Section VII** concludes.

I. Private equity, intangibles *and the rise of active management*

"The difference between PE and a plc is the level of 'sharpness'. In PE you have a shareholder who is sat at the table. You know their opinion. In the plc world you have a shareholder who is always one stage removed. Now I have lots of shareholders who all have expectations (dividend, cash, buy back, growth). It is blurred. With PE there is no misunderstanding of what is important to them. Timescales are more evident, there is a start and an end. That creates pace" **— Peter Pritchard, CEO of Pets at Home (until May 2022)**

"Business has to emerge stronger than it entered, with a better trajectory, a better outcome. And I think if private equity can't figure out how to do that – maybe there's, frankly, too much money chasing too few of those opportunities – it will struggle to perform relative to outward markets, so we'll see how it goes. But if the private equity fund doesn't have that perspective of taking businesses through a transformation, I think it'll be very hard to make returns. People at the exit are not idiots. A high percentage are corporates, who are not going to overpay for something which has peaked in value and so you have to show there is continuing growth" **— John Singer, Managing Partner at Advent International PLC**

"Some teams reach quite deep into a portfolio company through the governance model and the frequency of engagement. What's pivoting at the moment is that we are getting more and more requests from our portfolio companies for help. Some of that is for consultancy support. Which consultancy providers? Which data providers should we use? The drivers are a mix; sometimes it's the portfolio company, sometimes EQT. Having a very driven management team putting a lot of focus on this topic is attractive to us" **— Sophie Walker, Head of Sustainability for Private Capital Europe & North America, EQT**

"I think we have a problem in Britain in that most of the people working in PE or the management of PE and VC sector, learnt their trade in the City. The City is focused on public markets, highly regulated. Success looks like beating the benchmark by a few basis points. In the start-up world I am dismayed by the fact there is so much capital in London and yet such a tiny proportion actively invested into green field value creation" **— Norman Fraser, Co-founder and Chairman of SoftIron**

Current understandings of private equity have their roots in academic theorising in the 1970s and 1980s. In his seminal article, Jensen highlights the 'free cash flow problem' in poorly governed companies. Due to gaps in the market for corporate control and obstacles in monitoring by dispersed shareholders, mature companies with stable cash flows and few profitable investment opportunities may indulge in value-destroying pet projects and wasteful perquisites. Jensen argued that buyouts are optimised to mitigate these problems – on this account, debt not only provides a financial boost to returns via leverage but it also helps discipline management by reducing free cash flow.

This diagnosis struck a chord with contemporary anxieties. There was widespread unease that complacency had taken root in the corporate order as decades of success and a dearth of meaningful competition had bloated the conglomerates and bellwethers of the post-war economy to an unmanageable size. Many were wildly diversified, a grab bag of unrelated businesses that appeared to be run more in the interests of managers than shareholders or the wider economy. The private equity industry came of age just as these wayward structures collided with the more difficult economic environment of the late 1970s and early 1980s. A wave of buyouts sought to bring them into line, as immortalised in the book Barbarians at the Gate that chronicles KKR's bruising fight to buy RJR Nabisco, the food and tobacco giant that was widely seen as a poster boy for these excesses (Burrough and Helyar, 1989).

But as a product of its time, this account was also incomplete. Through its prism, information issues matter only in relation to moral hazard and other agency costs reflecting information asymmetries between insiders and investors.

In today's knowledge-rich economy, however, these preoccupations fail to do full justice to the importance of information in theories of the firm. Specifically, the evolution of firms towards having more intangible assets, including the strength of their stakeholder relationships, has put a premium on the ability to process complex, embedded and long-term information.

It means that more and more research is required just to get to a point where investors are capable of evaluating a company's prospects. While public investors can scrutinise 'hard' information such as quarterly earnings and other conventional financial metrics, they face free-riding problems and lack the incentives to produce this type of 'soft' information, particularly for smaller companies.[iii] This may arise even where the linkages between intangibles and firm performance are well understood: Boustanifar and Kang (2021) document how markets continue to undervalue intangibles like employee satisfaction more than a decade after they were first identified in the literature and notwithstanding the rapid growth of ESG investing (Edmans, 2011).

By contrast, private equity with its greater concentration of ownership and higher-powered incentives makes it easier for investors to distinguish between ESG appearance and reality and stay committed to a company's success. A lack of public stock prices and extended holding periods help insulate private equity from mercurial public markets. It means investors can take strategic decisions without the glare of quarterly earnings calls and the temptation to beat analyst expectations by managing earnings. As equity shares are privately held and lack liquidity, investors have an incentive to provide strong returns over the long term which they can only unlock after investments are exited rather than temporary uplifts in the stock price. Indeed, many PE funds continue to hold onto stakes after IPO and the end of lock-up period, even if their value effects are more ambiguous (Jenkinson et al., 2022).

This is obviously an over-simplification. It invites us to view public and private equity as in stark opposition and distribute terms of approval and disapproval accordingly when both are, in varying degrees, expressions of the shareholder value ownership model embodying the same strengths and weaknesses. But insofar as private equity can be thought of as a more extreme form of shareholder value, it avoids some of the incentive problems and monitoring costs evident in more distant and fragmented shareholder relationships.

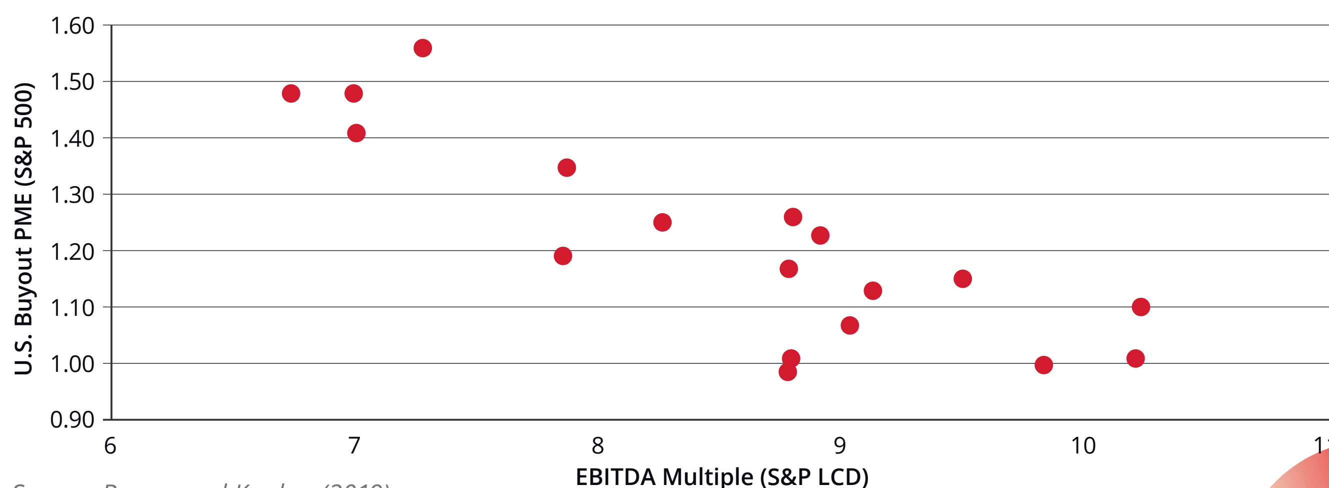
Consistent with this observation, Cornelli et al. (2013) find that 'soft' information plays a larger role than 'hard' information when it comes to deciding whether to replace a CEO. One explanation is that private equity investors, being fewer and closer to management, are able to tell the difference between the appearance and reality of performance and are less likely to fire a CEO for bad performance caused by events outside their control. Instead, they focus on a CEO's overall competence and other actions that provide context to the numbers. Specifically, missing hard financial targets increases the odds of CEO termination by 8.5 percentage points; but being viewed as incompetent on the basis of soft information increases the odds by 30.6 percentage points. The authors find that when CEOs are fired, companies see performance improvements and their investors are more likely to eventually sell them at a profit.

Innovation is another example of an activity that benefits from such proximity. A manager may be afraid to take a gamble on innovation if they face the risk of dismissal if that gamble goes wrong, even if it was the right thing to do in advance. After all, many ultimately successful innovations have missteps and bumps along the road. Having 'thickly informed', 'well-resourced' and 'highly motivated' investors like private equity can overcome this hesitation by reassuring managers that they understand these pitfalls, making them more willing to swing for the proverbial fences (Aghion et al., 2013).

These capabilities matter for activities and initiatives such as equality, diversity and inclusion in the workplace where box-ticking is a risk and meaningful and lasting change requires a full understanding of the context (economic, organisational, cultural, temporal) that enables them to be successful (or results in their failure) (Bohnet, 2016; University of York, 2022).

If anything, there are signs that private equity investors are getting more hands on with portfolio companies. Necessity as much as choice has guided this behaviour: as the success of private equity has attracted more capital to the industry and spurred many imitators, so competition for a limited pool of assets has increased, pushing up purchase price multiples *(see Figure 5)*.[iv] Buying at premium prices makes it ever more difficult to create value during ownership and exit with an acceptable return – a point well illustrated by Brown and Kaplan (2019) who find a clear negative correlation between the average price paid for businesses and subsequent PMEs *(see Figure 1)*[v]. This dilemma is exacerbated by the fact that global competition and commoditisation in product markets have made the traditional operational tools of private equity for generating outperformance, such as controlling costs and selling noncore assets, less effective (Khairallah and Quirici, 2021). These relatively easy gains have been achieved and PE firms are now having to take a much wider view of value creation to secure a competitive edge and produce desired returns for investors.

Figure 1: PMEs versus EBITDA Multiples from 1997 to 2014



Source: Brown and Kaplan (2019)

This is particularly true as buyout funds have moved into sectors like technology that are especially reliant on intangible assets to create value.

As part of this shift, PE firms are extending inhouse capabilities beyond the traditional 'high finance' skillset to include an operational element. The era when PE firms would simply appoint a new chairman and hold management teams feet to the fire at board meetings has given way to one where they are often found in the trenches, working alongside portfolio companies to establish a clear structure of initiatives and bring the right degree of focus. To this end, PE firms are starting value creation planning earlier in the investment process and taking a more balanced view on revenues and costs (KPMG, 2022). Likewise, value creation plans are becoming detailed and customised to each company's circumstances while there is a growing push to recruit operational talent covering a wide range of skillsets, seniority levels and objectives.

According to some estimates, the industry has 30% more operating resources at its disposal than it had just four years ago (E&Y, 2022). Examples include KKR that has established its own inhouse management consultancy – KKR Capstone – with over 90 full-time operating professionals and Clayton, Dubilier & Rice (CD&R) that recently hired the former CEO of P&G to join a deep bench of operating partners that includes former senior executives from Tesco, Johnson & Johnson and PepsiCo.

Still an era of truly active management remains a work in progress rather than a solid achievement and the challenges in realising it should not be underestimated. KPMG (2022) reports that only around 1 in 10 PE firms believe they have reached the full potential on their investments 90% of the time. McKinsey (2019) observes that few PE firms truly qualify as 'active performance partners' with most coordination taking place in a sporadic and haphazard fashion – for example, nearly half of interviewees in its survey will only intervene with management if there is deviation from the value creation plan for at least three consecutive quarters.

The role of operational engineering has been brought into sharp focus by the growth of the secondaries market, involving PE funds selling businesses to each other. PE-to-PE sales accounted for 26% of all deals in 2021 – up from 19% in 2020 with GP-led transactions now accounting for half of the secondaries market. This continuity is appealing from an operational perspective where the buyer has capabilities that the seller does not – for instance, a modest-sized industry specialist identifies the main binding constraints to a company and subsequently sells its stake to a larger firm that can inject fresh capital to execute or scale up a growth plan (Degeorge et al., 2016; Ivashina and Lerner, 2019). However, not all transactions fit this profile since they often involve the sale of the firm between funds that are similar in skill set, thereby limiting these types of synergies (Martin, 2022). Other things being equal, it will be harder to find new sources of value and capture the remaining upside in a company as it passes through more owners' hands. This is especially true with secondary buyouts that are made late in a buyer's investment period when considerations other than the ability to make operational improvements may be guiding behaviour (Arcot et al., 2015; Degeorge et al., 2016).

As operational considerations loom larger, so private equity is discovering that it is not exempt from the rules of the road that apply to other organisational transformations. Biesinger et al. (2020) find that the particular choice of strategy is often less important than whether action items are actually implemented; however, resource constraints, data fragmentation, economies of specialisation, minimum holding periods, low levels of trust and diminishing returns all pose barriers to successful execution. McKinsey (2020) finds that fewer than one-third of organisational transformations succeed at improving a company's performance and sustaining those gains.
There is even less margin for error for PE firms that typically have a shorter time frame to realise change efforts than other strategic investors.

A particular challenge for PE firms is collecting, analysing and actioning relevant data. Real-time data is vital to help PE funds monitor operations and understand what creates value at portfolio companies; but reporting relationships and the flow of information can be cumbersome as companies do not always share access to these systems with the PE firm (PWC, 2021). To exacerbate matters, data is often buried within individual departments – financial, sales and marketing, supply chain, human capital and technology.

This comes with a host of IT issues (fragmented systems) and cultural issues (insular and territorial business units).

The task of shepherding this activity and communicating with investors falls on CFOs who are often new to the company and lack the reputation and relationships among key stakeholders in the organisation to draw on (Agrawal et al., 2020).

Among the more consistent findings to emerge is the interdependence between sector expertise and successful execution. Spaenjers and Steiner (2021) compare specialist and generalist private equity investors in the US hotel industry and find that specialists are associated with greater improvements in operating efficiency, higher bottom-line profits and superior capital gains after exit. By contrast, PE generalists' main comparative advantage in the sector lies in superior access to cheap financing, albeit the effect on performance is limited. In a similar spirit, Bernstein and Sheen (2016) find that deals led by private equity partners with prior experience in the restaurant industry outperform those led by partners with financial or banking resumes. Operational improvements are strongest in 'softer' areas related to food handling that are not easily sharpened through capital reallocation or codifiable in a handbook.

The value of these skills may appear obvious but they are not always at the top of investors' minds – interestingly US PE firms have a stronger preference for deep sector expertise when bringing in external advisors than their UK counterparts who place more weight on a successful track record (KPMG, 2022).

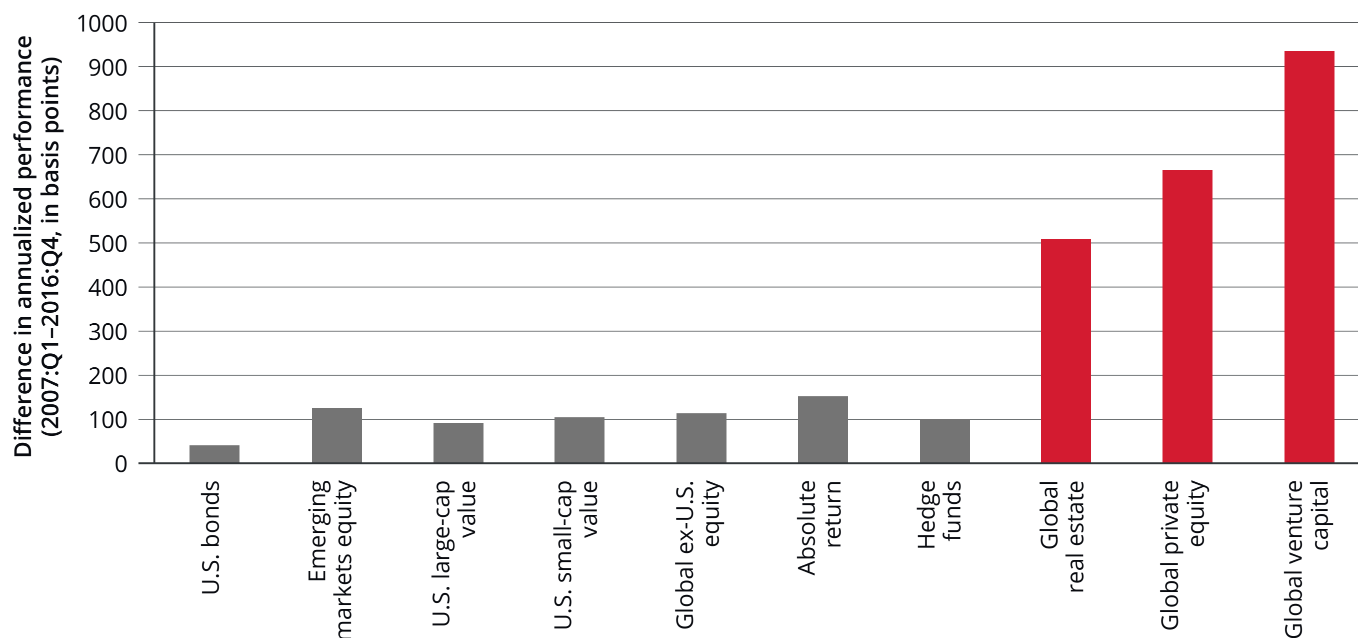
II. Beyond one-size-fits-all: the importance of *buyout type, economic conditions and sponsor characteristics for outcomes*

> *"If you're running a ten billion fund, you are doomed to put half a billion into any given deal. That's equity but then at least as much in debt, possibly a bit more so you're after one billion pound plus targets. In the UK that probably means there are about sixty available total targets. The available market is getting pretty thin and as they go for larger and larger funds, which are irresistible because a ten billion fund is giving you one hell of a lot in management, transaction and exit fees. Scale matters but they are beginning to run out of prey. Indeed, it was one of the theories as to what happened to the dinosaurs. They ran out of prey and you know there's something about that going on now. We have reached the size limits of the industry pretty well and you also see the very large funds getting rather accident-prone and less publicly, the SoftBank fund for example which it now transpires was happy to do very large investments with hardly any due diligence"* **— Jon Moulton**

> *"It is important to remember that in Private Equity, over the past decade, 80% of investments (by number) go into businesses employing fewer than 99 people. What journalists write about are the big multi-billion-pound funds, but that is not where you will get the best practice of purpose"* **— John Singer, Managing Partner at Advent International PLC**

Beyond this distinction between specialists and generalist lies a more fundamental point: private equity is not a homogeneous universe. If so, then one should be sceptical of bold declarations or consistent narratives that assert all private equity is good or bad. Intuitively, this point can be seen in the wide dispersion of returns – long a defining feature of private equity as an asset class and one that contrasts strikingly with public equity and bond markets *(see Figure 2)*. Indeed, it is not the mere fact of heterogeneity per se, and the visible manifestations of it, that is so illuminating, but also the enormous variety of levels at which this heterogeneity operates and has an impact; so many that it is difficult to know what additional detail adds texture to the larger picture as opposed to overloading it.

Figure 2: Difference in annual return (1st quartile vs. median)



Source: Ivashina and Lerner (2019).

IIa. Buyout type

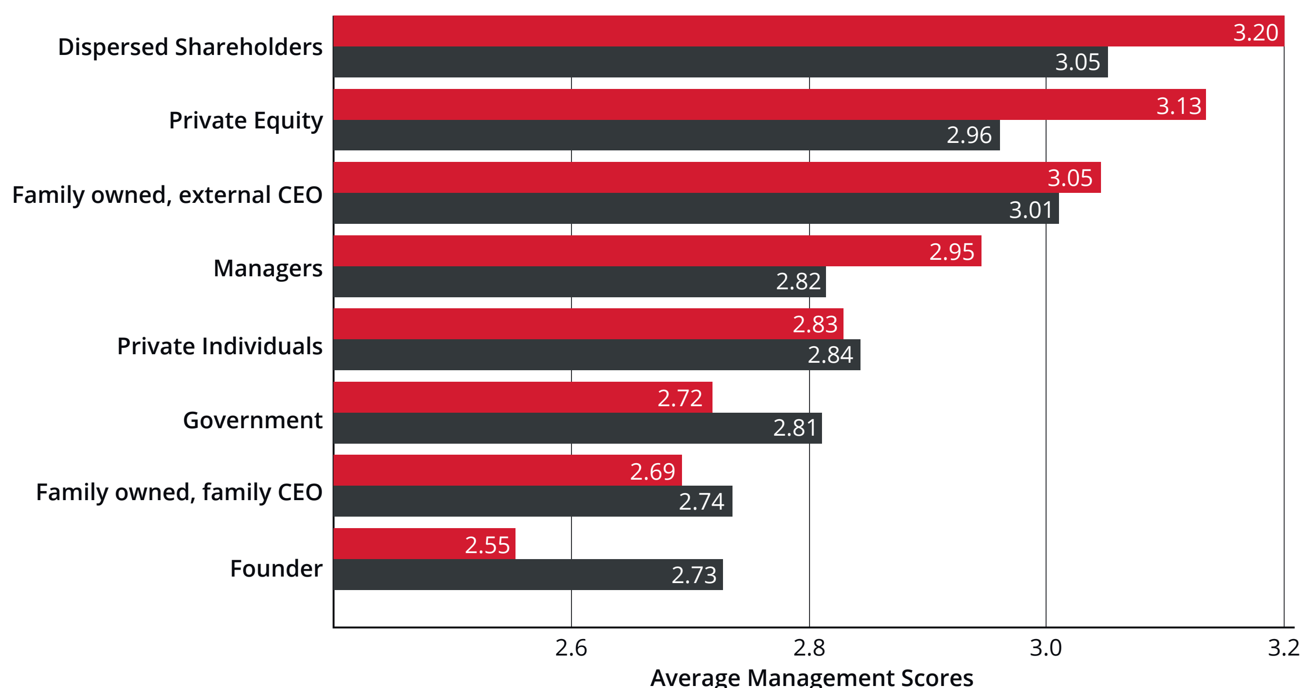
Researchers and practitioners are beginning to lift the lid on these issues. Perhaps the strongest suggestion generated by this work is the importance of pre-deal ownership type: publicly listed companies that are taken private experience fundamentally different changes from buyouts of other private companies, with divergent effects for stakeholders.

Productivity gains are associated more with private-to-private transactions, as reflected in superior growth in profitability, employment, sales, capital expenditures, export patenting activity while wealth transfers appear more commonplace in public-to-private transactions (Lerner et al., 2011; Cohn et al., 2014; Amess et al., 2016; Cumming et al., 2020; Lavery et al., 2021; Cohn et al., 2022).

There are a number of reasons why private-to-private transactions may do more to grow the pie. First, targets of private-to-private deals are more likely to be credit constrained before the buyout than publicly held firms (Boucly et al., 2011). In other words, private equity funds help companies realise unexploited growth opportunities by alleviating financing constraints. This is particularly true for countries with relatively underdeveloped capital markets or industries that are more reliant on external finance.

Second, the payoffs to operational improvements tend to be larger at private firms than public firms. Bloom et al. (2015) find that PE owned companies have better management practices than family and founder owned firms *(see Figure 3)*. Many family and founder owned firms struggle with the transition from one generation to the next when there is often a conflict between the desire to maintain and respect tradition and entrepreneurial instinct and the need for further professionalisation to create the foundation for the next phase of growth. By contrast, the quality gap in management practices between PE owned portfolio companies and publicly listed firms is much smaller – indeed, publicly listed firms may have a small advantage over PE firms, reducing the scope for buyouts to add the same value.

Figure 3: Average management scores across ownership types



Notes: Management scores for 15,038 firms. Raw data and with country and 3-digit SIC industry controls.
Source: Bloom et al. (2015).

Third, private companies supply the raw material for value creation strategies such as buy and build. This enables PE firms to roll up many small competitors into a larger platform company to achieve synergies, economies of scale and rationalisation of support functions as well as exploit residual valuation differences ('multiple arbitrage') between different sized companies.

Finally, private-to-private deals employ less leverage and are less likely to encounter financial distress than public-to-private deals (Axelrod et al., 2013). This puts management and investors on a stronger footing during economic downturns and ensures they are better able to stick to their pre-buyout value creation plans than buckle under short-term pressures. Fortunes contrast most sharply with transactions that need to refinance debt at a higher rate in subsequent years than that agreed at the time of the investment (Cumming et al., 2020).

Take-private transactions, often involving 'proud old companies' whose glory days are behind them but still command affection and loyalty, maintain such a grip on public attention that our judgements of private equity are largely derived from these experiences. But the more prosaic reality is that these transactions and the concerns they raise constitute only a small share of overall PE activity. Over the past decade, private firm buyouts have outnumbered buyouts of publicly traded firms in the US by more than thirty to one, though the difference is less stark in value terms. For the public, these transactions are easy to overlook: each, on its own, is unlikely to affect economic outcomes but added together, they are capable of moving the dial and implicitly lead greater optimism about the effects for purpose of PE ownership.

IIb. Macroeconomic and credit conditions

It is widely understood that the flow of capital to private equity and its performance are highly cyclical. Hidden from view is that the choice of value creation strategies also cycles through the same recurring patterns. Davis et al. (2021) find that when credit is cheap and readily available, PE firms focus on delivering returns via financial engineering such as issuing new debt to fund additional dividend payments to equity holders and exploiting the spread between cheap borrowing costs and the returns earned by portfolio companies. By contrast, deteriorating economic or tighter credit conditions make financial engineering less viable, compelling PE firms to emphasise operational improvements instead in order to create value.

To some readers, this may sound like a difference without a distinction. After all, both financial and operational engineering can be highly profitable for shareholders. However, their implications for stakeholders differ enormously: while financial engineering is, at best, welfare neutral resulting in no net new value creation for society, operational improvements raise productivity in portfolio companies and make the economic pie bigger than it otherwise would be – a statement which is consistent with observed productivity differences between buyouts executed at different stages of the economic cycle. Indeed, there are reasons for thinking that buyouts may underperform when financing is abundant. The combination of numerous PE firms with cash to spend when financing is easy may prompt deals of inferior quality with less potential for value creation in the form of operational improvements. In turn, a larger deal flow may overwhelm the monitoring and governance capabilities of PE firms, restricting the time they can allocate to any given portfolio company.

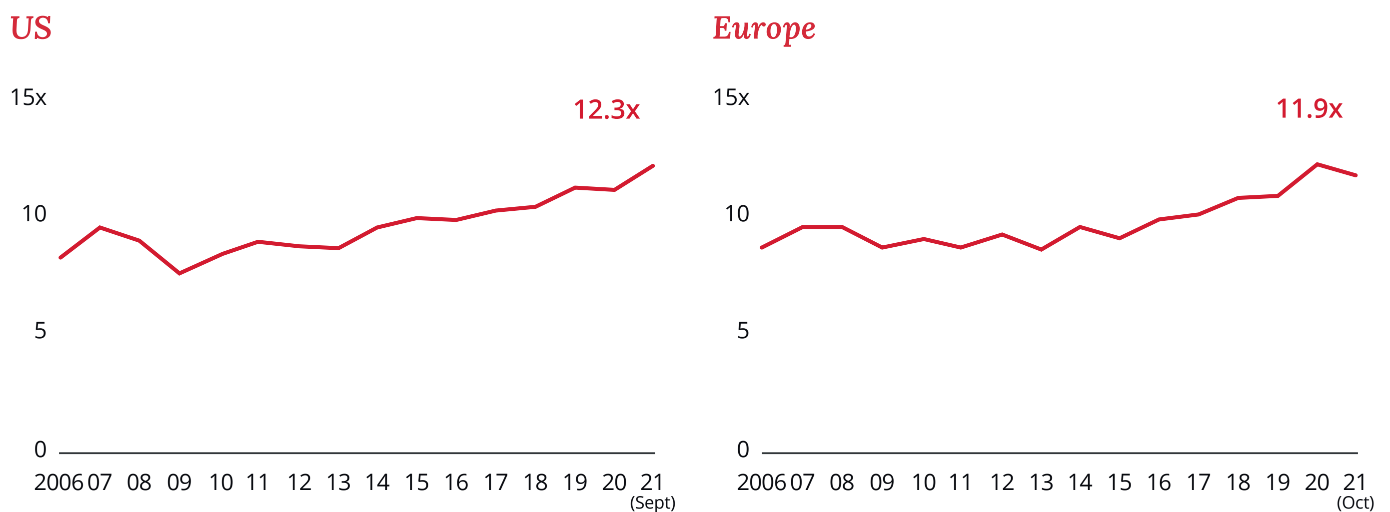
The tendency for PE firms to place greater emphasis on financial engineering in 'good' times is not surprising: many partners at PE firms cut their teeth in investment banking that pioneered and perfected these techniques, leaving an imprint on specific firm strategies. Rather it would be odd to expect them not to stick to their knitting and forego an open goal when leverage and dividends deliver such high private returns.

At the same time, if this story has legs, it raises distributional questions about the trajectory of recent PE activity. Economic conditions of the last few decades have underwritten a long ascent in the majority of asset prices. In the wake of the financial crisis of 2008, central bank intervention put a floor on downside risk for investors, keeping markets not only liquid but prospering. The downward trend in interest rates, inflation and risk premia, in turn, created incentives for investors to take on greater duration or credit risk or employ additional leverage as they reached for yield. While these arrangements were envisaged as temporary, in practice, weaning markets off them has proved elusive, with investors conditioned to expect policy support when growth faltered. Quantitative measures of financial conditions suggest that investors never had it so easy during this period, including private equity that benefitted from a flow of money into the asset class, as reflected in higher purchase prices, large and growing dry powder and greater use of leverage[vi] *(see Figures 4 and 5)*. Steffen Pauls, founder and chief executive of Berlin-based private equity platform Moonfare, is blunt in his assessment: "The past 10 years in private equity have been the best years for the industry more or less ever. It was very, very difficult not to make money" (Oliver, 2022).

Figure 4: US Financial Conditions Index

Source: Goldman Sachs (2022)

Figure 5: Average EBITDA purchase price multiple for leveraged buyout transactions in US and EU

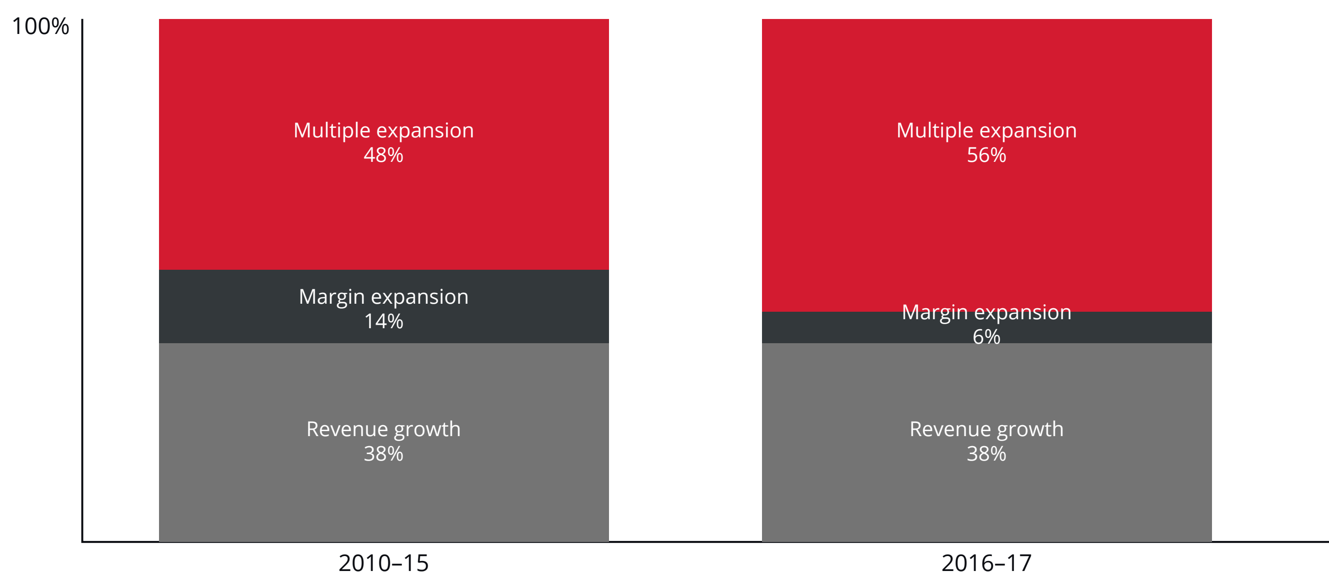


Source: Bain (2022) based on S&P LCD data

Against this backdrop, a rising tide has lifted all boats. Bain (2022) finds that in the second half of the decade, PE investors generated their returns by simply selling at a higher multiple (see Figure 6). This 'multiple expansion' means that companies were able to realise an increase in value in the absence of operational improvements. Indeed, the average PE fund appears to have become less successful at improving the performance of its portfolio companies with the share of returns coming from operational improvements – margin expansion – more than halving to 6%. The main exception to all this is the software and technology sector that has become a core area of focus for the buyout industry – and where organic drivers have made a more balanced contribution to returns.

Holding periods offer another missing piece of the puzzle. Bain (2022) observes that the average holding period for PE assets has fallen steadily from 5.8 years in 2014 to 4.4 years in 2021 *(see Figure 7)*. Again, this is revealing about investor choices and incentives: where multiple expansion does the heavy lifting, PE firms can buy a company, lever it up, and exit sooner, moving on to the next deal, confident that rising asset prices will deliver the kind of double-digit returns investors have come to expect. The constraints imposed by shortening holding periods also sit uncomfortably with the demands and opportunities for more sophisticated active management that are slower to bear fruit (Ivashina, 2022).

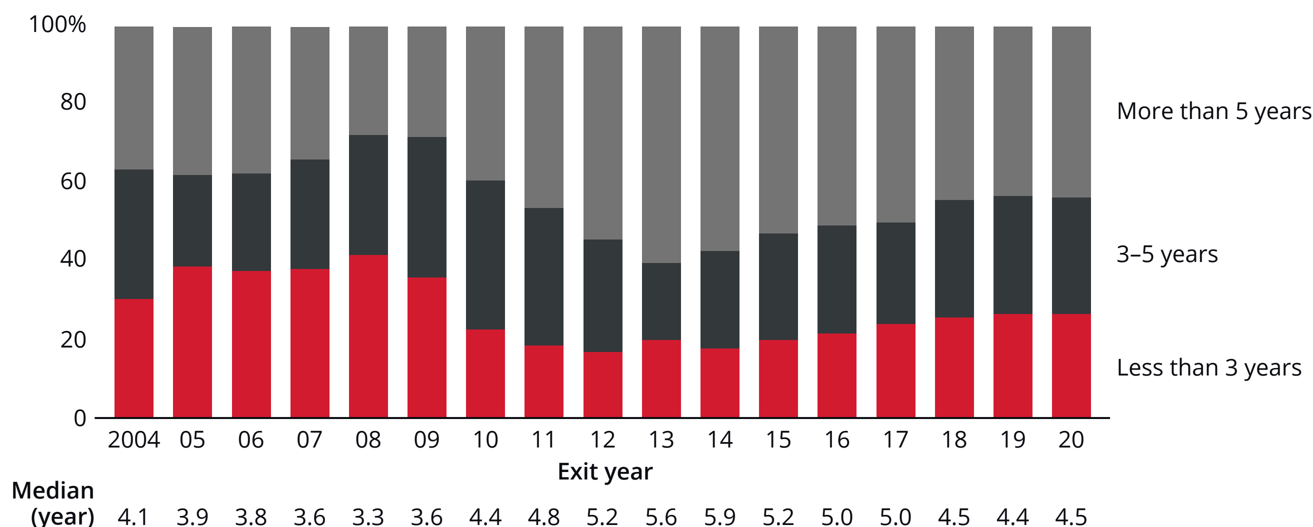
Figure 6: Median value creation, by year of exit



Notes: Includes fully realized global buyout deals with more than $50 million in invested capital: excludes deals with missing data; excludes real estate and infrastructure deals; 2021 data as of 14 December 2021

Source: Bain (2022) based on CEPRES Market Intelligence data

Figure 7: Global buyout-backed exits, by length of time held in fund portfolio



Notes: Includes buyout, public-to-private, special situation and turnaround investments, as well as exits through IPO, merger, sales to GP/management, trade sale or unspecified exits; excludes partial realizations, except for IPOs

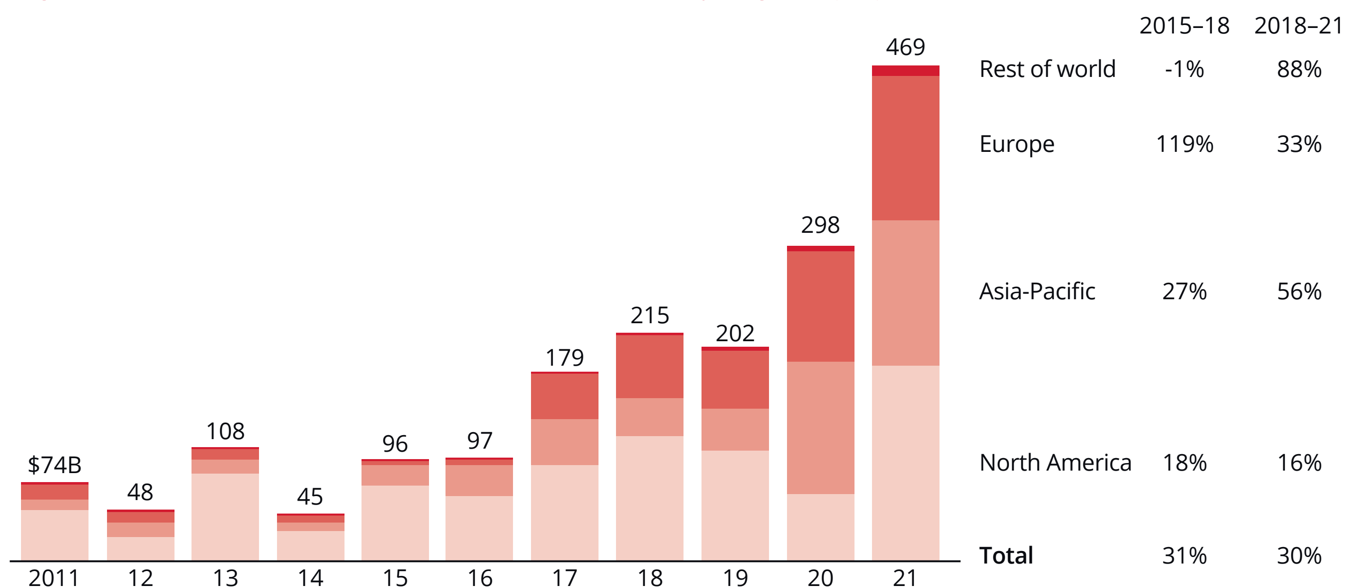
Source: Preqin

Macroeconomic conditions also interact with buyout type in ways that raise challenges. Over the course of the market cycle, there is often a sharp increase in public-to-private transactions. This present cycle has been no different: the need and opportunity to put record amounts of dry powder to work has incentivised PE firms towards take-private transactions. This activity typically involves very large, established companies and is therefore capable of absorbing large amounts of capital. The previous occasion the market produced such a rapid increase in large public-to-private transactions was in the run-up to the global financial crisis in 2006-07. Given many of these transactions went on to struggle – indeed returns from PE funds raised in these years were the industry's worst in the past two decades, these parallels could be seen as a cause for concern. Indeed, in 2021, PE investors paid higher multiples for publicly listed companies (19.3x EV/EBITDA) than they did in 2006-07 (12.6x EV/EBITDA).

But that is where the similarities end. Reflecting on the period 2006-07, Bain (2022) observes that deals were generally larger, both in absolute terms and relative to the rest of the market. Among the top 10 public-to-private deals in that period, not a single one fell below $24bn whereas the largest deal in 2021 was McAfee at $15.4bn, including debt.[vii] One consequence of large deal size was that it necessitated consortia of buyers – groups of large private equity funds thrust together to get deals over the line. In hindsight, many resembled hasty marriages of convenience that resulted in laxer due diligence and design by committee with all its attendant problems – a loss of focus, disjointed compromises and difficulties in establishing coherent value creation plans.

Not only have deals in the present cycle been smaller by comparison but they have been generally led by sector specialists. This is another contrast with 2006-07 that was typified by deals like Terra Firma's ill-fated acquisition of music group EMI. Up until that point, Terra Firma had been best known for its successful turnaround of Tank & Rast, the German autobahn service operator but it was an experience that offered limited guidance, at best, to the idiosyncrasies of managing a creative organisation like EMI, particularly one that was pivoting through the disruption of piracy and digitisation. In short, PE is today a much more mature and sophisticated industry than it was in earlier cycles.

Figure 8: Global public-to-private deal value, by region ($B)



Notes: Transactions based on announcement data; includes announced deals that are completed or pending, with data subject to change; geography based on target's location

Source: Bain (2022) based onPreqin,Dealogic and AVCJ data

IIc. Sponsor characteristics

It is important to see both the forest and the trees. Investment strategies and associated performance outcomes reflect not only influences external to the firm but also factors that operate within firms and over which they have direct control. Davis et al. (2021) find that PE groups have a distinctive investment style that is sticky over time and influences how they approach value creation at target firms. It is difficult to parse the DNA of buyout groups – a fissiparous mix of people, place, time and philosophy that has evolved through different market regimes and historical accidents. But evidence suggests that the career backgrounds of founding general partners leave a particularly strong impression on the strategies of PE firms – one that can still be felt well after the circumstances that gave rise to them have faded away (Gompers et al. (2016). All this suggests that PE firms cannot readily shake off the past and reinvent themselves but more constructively a reputation for purpose or ESG is likely to be credible, providing assurance to investors that this information can be used to guide manager selection decisions.

Another feature of sponsor characteristics bearing on these questions is size. Kaplan and Schoar (2005) find that, for funds raised by the same GP, a 50% increase in fund size is associated with roughly a 0.07 decline in PME, which translates into a 1.5% to 2% decline in a fund's IRR. In a similar vein, Lopez-de-Silanes et al. (2015) find that investments held by private equity firms in periods with a high number of simultaneous investments underperform substantially. These costs are not limited to investment returns: Davis et al. (2021) show that rapid upscaling in buyout activity is associated with a more negative employment impact on target firms, after controlling for buyout type and the target's pre-buyout growth history. Similar patterns are reported for other asset classes and investment vehicles such as public equities and hedge funds.

It is unclear what precisely is going on: one possibility is that past successes encourage PE firms and funds to ramp up their investment activity, making it harder to keep an eye on deals, manage workloads and ensure consistent quality standards.[viii]

Another possibility is that the increasing scope of funds' portfolios induced by scale leads PE funds to include companies in more industries and wade in unfamiliar waters, with the result that they come to resemble, somewhat paradoxically, the sprawling conglomerates that they once broke up (Fung et al., 2008; Gompers et al., 2009; Lopez-de-Silanes et al., 2015; Vandevelde, 2021).

Complementary work also points to the tendency for incentives to become less aligned as PE sponsors grow in size. Jenkinson et al. (2021) observe that hurdle rates and carried interest hardly deviate across buyout funds. GPs almost always have a hurdle of 8% and a carried interest of 20%. In economic terms, this bunching is curious: one would expect top performing GPs to capture a higher share of the profits over time. It turns out that gains to success are largely realised by growing the fund size while keeping the management fee constant. This fixed element makes compensation less sensitive to the performance of individual companies and can encourage asset gathering behaviour in order to collect management fees, potentially leading funds to grow beyond what is socially optimal. These arrangements are complicated by the fact that major PE groups are now publicly listed, meaning that they must serve two masters – public shareholders and LPs. Evidence suggests the share price of PE firms is principally driven by discounted future fees while any forecasted carry is so uncertain that its impact on share price is negligible. This gives PE firms an incentive to chase fees which makes public shareholders happy but, in turn, leaves LPs, who would rather pay for performance, increasingly unhappy.

These concerns are not new but they have taken on more urgency with the growth of mega-funds: in 2021, the largest PE funds – those with assets under management greater than $5bn – attracted nearly half of all buyout capital raised. On the other hand, these findings are only averages – there are many examples of funds that have grown successfully while generating attractive returns for investors. Moreover, practitioners observe that large funds meet a particular need for investors. For example, monitoring difficulties have seen LPs cut down the number of funds in which they invest and gravitate to larger funds that can absorb the resulting inflows. In turn, GPs tend to provide better terms to LPs with the largest commitments. There is also evidence that the dispersion of returns is less pronounced in mega-funds than smaller funds, making them a safer bet for investors who are concerned about downside risk. Finally, LPs value the range of services that the largest managers provide, including risk management, access to co-investment opportunities and other asset classes and sound ESG policies. Still, this discussion is a salutary reminder that growth brings significant challenges and investors should bear them in mind at a time when the big continue to get bigger.[ix]

III. Leverage, *risk and purpose*

> *"There's no cost without benefit or benefit without a cost and if you were private equity, a lot of it is the use of very heavy levels of debt leverage. People who lived through 10% base rates and the like tend to have much more debt aversion than people who think that a 2% rate is painful. In 2008 credit markets tightened up but then the important thing was interest rates went down, not up, so it turned out to be quite good when everybody was initially very fearful. Today there is clearly much more risk in the process, much more, and these subscription or funding lines are potentially explosive. Somebody somewhere will abuse them and scam them"* **— Jon Moulton**

No issue is arguably more controversial yet less understood than the role of leverage in private equity transactions. While private equity is a product of constant evolution, it could not exist without debt. It is the rocket fuel that makes a corporate acquisition so lucrative for investors, magnifying gains if it sells at a profit. Critics claim that high debt levels put pressure on companies to use their cash flows to service the debt and manage covenant constraints at the expense of long-term investments (e.g. innovation, safety, purpose). This is based on the idea that substituting debt substitutes a fixed interest obligation for optional dividends that were previously paid to shareholders. The greater rigidity implied by debt – unlike equity that adjusts automatically with servicing capacity – therefore leaves firms' prospects and discretionary expenditures more vulnerable to negative shocks, potentially hurting stakeholders.

What should we make of these claims? Matsa (2011) finds that highly levered supermarket firms, that sometimes become so through private equity buyouts, experience higher inventory shortfalls and stockouts as cashflow that could be used to improve product quality is preserved for debt service. Giroud and Mueller (2017) show that firms that had built up their leverage prior to the 2008 financial crisis were responsible for most of the subsequent contraction in employment across US regions, suggesting that firms with high leverage ratios are not only more vulnerable during economic downturns but may also propagate these vulnerabilities to the wider economy. Ahn et al. (2020) also show that these firms are more likely to cut intangible investments than tangible investments – presumably they are harder to pledge as collateral and translate quickly into sales. Finally, Jungherr and Schott (2022) find that high levels of firm debt issued during expansions are only gradually reduced during recessions, slowing down recoveries.

The obvious rejoinder is that these findings apply across the board and are unrepresentative of private equity ownership. One possibility is that PE funds are choosing the 'optimal' leverage ratio to maximise the tax, leverage and disciplining advantages of debt while minimising its bankruptcy costs, carefully matching the capital structure of portfolio companies to the characteristics of their assets and ability to meet interest payments. For example, utility companies are possessed of simple business models, often with revenues that are highly predictable and linked to inflation. They are subsequently easy to leverage, making a fund's precious equity stretch the extra mile. The same considerations explain PE's growing interest in historically volatile sectors like software where more and more companies are transitioning to subscription models (SaaS) that serve to smooth out revenue and cash generation.

By contrast, leverage should decrease in firms with higher levels of operating risk, growth opportunities and asset intangibility.

The logic behind these claims is compelling and elegant but the actual evidence supporting it is mixed. Firm characteristics, of course, matter but as Axelson et al. (2013) observe, the extent of leverage in buyouts is often driven more by interest rates and general credit conditions with PE firms levering up as much as possible when credit is cheap and arbitraging between debt and equity markets to magnify returns. As for the role that the discipline of debt plays in these trade-offs, PE firms already have high-powered incentives that make high debt levels somewhat redundant for this purpose.

Alternatively, it might not matter all that much that PE firms deviate from the optimal target leverage. As expert, repeat and largely financially motivated players in capital markets, they are arguably more skilled at managing its effects than other companies.[x] Hotchkiss et al. (2021) find that PE owned companies have higher leverage and, due to this leverage, default at higher rates than other companies borrowing in leveraged loan markets. But controlling for leverage, PE owned companies are no more likely to default – moreover when they do default, they restructure more rapidly and frequently out of court and are more likely to survive as an independent going concern. Leveraged buyouts also have significantly weaker loan agreements via deductibles and carve outs that may shield financial sponsors from financial distress, notwithstanding the fact that this may impose hidden costs on creditors and other stakeholders if these complex risks are not appropriately priced (Ivashina and Vallee, 2022). Bernstein et al (2018) find evidence that during the Global Financial Crisis, PE owned companies decreased investments less and had higher growth than their peers while maintaining similar levels of profitability. More impressively, PE-backed companies experienced an 8% increase in market share relative to matched firms during the crisis and were about 30% more likely to be targeted in a potentially profitable M&A transaction in the post-crisis period. These results are explained by the ability of PE owned businesses to draw on the resources and relationships of their sponsors to raise equity and debt during this challenging period. So far from being an albatross around the necks of PE funds, dry powder – capital raised but not yet invested – served as a critical lifeline and source of liquidity for portfolio companies.

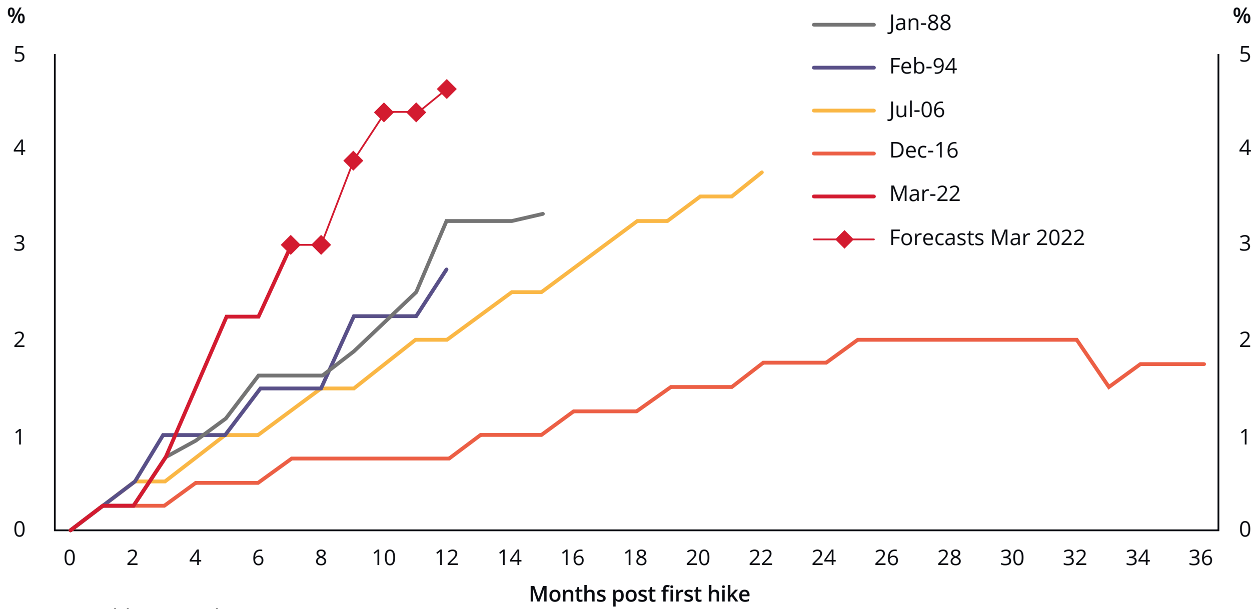
Explicitly stated or tacitly affirmed, this experience runs counter to the claim that PE firms increase financial fragility and supports the generally sanguine view of the costs of leverage in private equity. It also provides confidence that the industry will be able to weather future economic storms. However, before we readily accept this conclusion, we should apply at least two brakes.

In the first place, the 2008 crisis was marked by a swift V-shaped rebound with indicators of financial health such as high yield credit spreads returning to pre-crisis levels within less than 10 months. It is not inconceivable that a more protracted economic downturn would place greater stress on portfolio companies. Any future downturn, moreover, is likely to be quite different from previous ones. Recent bear markets have all taken place in a deflationary environment. In the past, central banks were quick to come to the rescue of markets by cutting rates.

By contrast, over the past year, investors have been wrestling with the very opposite conditions – the fastest and most aggressive hiking cycle in more than three decades amid rising inflation and the withdrawal of liquidity through quantitative tightening (QT) *(see Figure 9)*.[xi]

The consequences are particularly relevant for sub-asset classes like growth equity that has been adding assets under management (AUM) at around twice the rate of buyouts over the past decade. Higher interest rates increase the discount rate applied to estimate the future cash flows of companies, penalising more speculative ventures whose peak earnings are projected further into the future. While inflation is expected to fall in headline terms – in some cases, moderating quite substantially, a simple return to the status quo ante appears less likely in the foreseeable future (MGI, 2022; Rajan, 2023).[xii]

Figure 9: Cumulative Fed funds rate hikes in the past four cycles



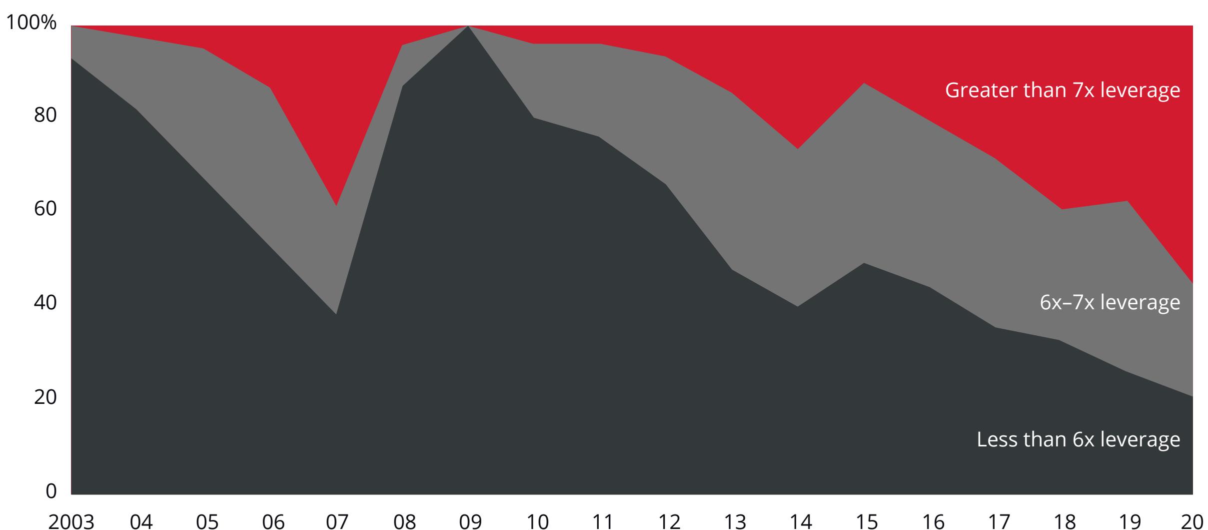
Source: Goldman Sachs (2022)

The residual effects of the supply shock arising from the pandemic and war in Ukraine and wider geopolitical threats, a shift in economic and philosophical focus from efficiency to resilience but also years of underinvestment in production capacity and an ageing workforce, if anything, raise the prospect that some inflationary pressures could persist over the medium to long term, impacting policymakers' ability to respond to future recessions.[xiii]

The second brake we should apply to the idea that history will repeat itself is that debt loads in the US buyout market are at their highest level in recent decades (Bernstein et al., 2020). In the US, over 80% of deals are leveraged at more than 6x EBITDA – historically the level at which regulators around the world have started to ask questions *(see Figure 10)*. On the other hand, despite the increase in leverage ratios post-financial crisis, debt as a percentage of total enterprise value (D/V) is today lower than in the past, highlighting the equity cushions available to buffer lenders if asset prices fall.[xiv]

However, figures may understate the true leverage deployed in private equity investments. At a fund level some PE managers use subscription credit lines to reduce the relative amount of equity and delay capital calls, adding incremental leverage to LPs (Albertus and Denus, 2020; Moulton, 2022).

Figure 10: Share of US leveraged buyout market, by leverage level



Source: Bain (2021) based on Refinitiv data (2021)

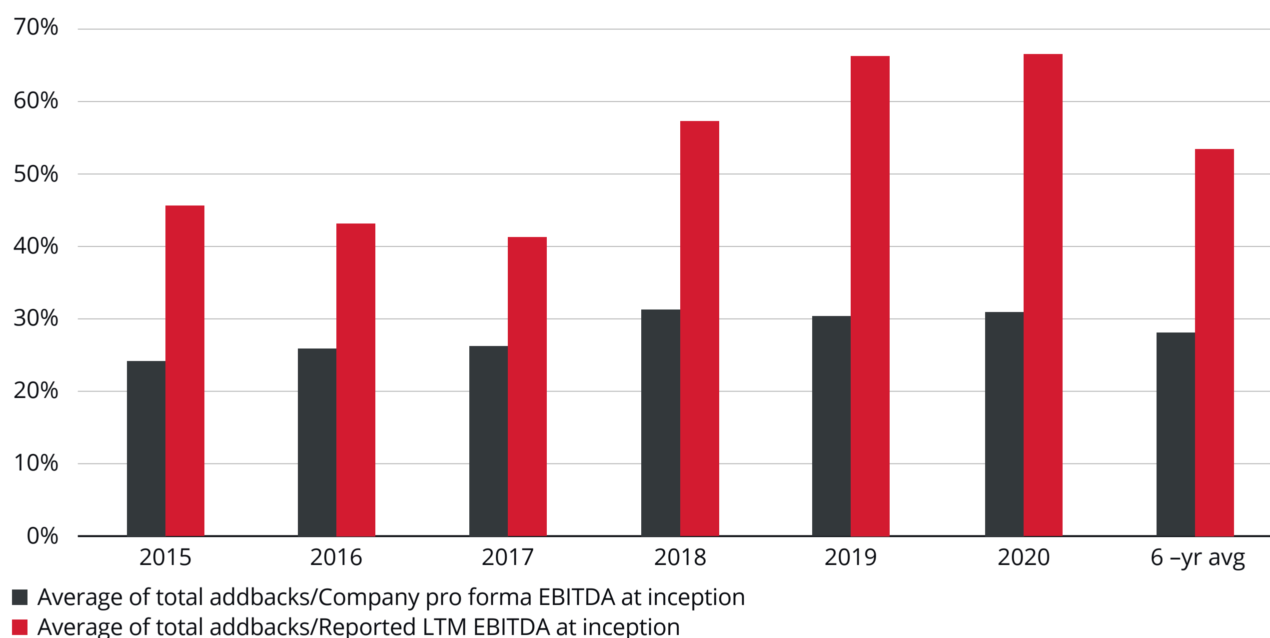
Even when a private capital provider invests equity into an investment, that equity can be sourced from debt. More important, an increasing number of deals are valued on the basis of projected earnings rather than actual results (IPC-PERC, 2021). Such adjustments or add-backs tend to price in expectations for cost savings, synergies and revenue increases regardless of whether they are achieved, in the process making leverage ratios look lower and interest coverage ratios look higher than they are.[xv] On average, over the past six years, addbacks have made up over 28% of marketing EBITDA and over 53% of LTM reported EBITDA *(see Figure 11)*.

It is unclear how unruly the genie of adjusted EBITDA could turn out to be, not least because valuations in private markets are updated much more slowly in public markets.[xvi] What is clear is that these practices have dialled up the heat on PE funds to execute flawlessly on value creation plans with risks skewed to the downside.[xvii]

S&P (2022) finds that for the most recent cohort of deals, about 70% of the companies missed their EBITDA targets by at least 25% in the following two years with a median miss of approximately 40%. It is notable that the plurality of addbacks in recent years have come from expected cost savings that could be harder to achieve if inflation turns out to be more persistent and businesses cannot effectively pass on higher costs to their customers (GSAM, 2022).

Finally, broader market stress could make it harder for PE funds to deploy 'dry powder' to cushion losses and provide support to portfolio companies due to the risk of broken capital calls and the opaque interconnectedness of different parts of the financial markets (Deutsche Bank, 2022).[xviii] None of this is to say that a prolonged economic downturn or meltdown in private markets is on the cards. At the time of writing, despite uncertainties about the macroeconomic outlook, there are rising hopes of a soft landing, namely central banks in the US and elsewhere will be able to raise interest rates enough to tame inflation but not enough to push economies into recession. Even sceptics are far less bearish than they were several months ago. These scenarios are better seen as low-probability, high-impact tail risks. Rather it is to point out that changing conditions are likely to bring new challenges, that markets can often appear calm but are subject to powerful undercurrents with crises evolving in a non-linear fashion -'gradually then suddenly' to paraphrase Ernest Hemmingway- and that the unspoken assumptions and beliefs that investors have embedded in recent years about how the world works should not be taken for granted.

Figure 11: EBITDA Addback Trends (2015–2020)



Source: Standard & Poor's Financial Services (2022)

IV. Private equity's approach to ESG and purpose and enlightened *shareholder value as a basis for action*

"One of the biggest shifts within Private Equity has been that from risk and compliance to a value creation model. It was a lot of risk, and it still is, but PE firms have realized they can do good with the tools and structure they have, which investors are pushing for as well" **— Allegra Day, ESG Director, Cinven**

"I think companies entering the portfolio now would struggle if the management team weren't willing to engage on ESG issues. But that is not to say that a social or environmental purpose has to be the driver, per se. It may not be right for all companies in all situations. It is perhaps easier for some companies (especially consumer facing and/or small companies), and I wonder if for that middle ground of companies whether 'purpose' really is the right way to go. I would feel uncomfortable saying that all businesses have to have a purpose" **— Jennie Galbraith, ESG Director Inflexion**

"Talking to small and medium sized players in the market, they do as little as they can. They get a checklist to make sure they've considered all the hotspots. Quite a lot of the big players have got somebody whose job it is to portray things as well as possible" **— Jon Moulton**

"We've always had the mindset that everything we invest in, no matter what the regulation allows: Is it value for money? A good outcome? Is it fair? Because if we can check the boxes on all those things, it's very unlikely that we will get into trouble such as not meeting regulatory requirements, getting 'caught out' in the press, or having investors being unhappy with investments that we made and punish us by not providing us with new, fresh capital, the next fund" **— Peter Deming, Manager Director, Warburg Pincus**

"From a commercial standpoint, if a PE-backed business is to be floated, having regard to purpose and ESG is vital. I say this because purpose is about doing a better job, about reputation, feedback and employee engagement. If you are going to be successful post IPO (unless absorbed) to create momentum you need to find your purpose and deliver on it" **— Sir Michael Rake**

The progress of ideas is one of zigzags and reversals, reflecting the tug of war between believers and sceptics, sometimes advancing, sometimes retreating. This is especially true when an idea bursts into prominence: it can emerge so quickly that it is carried far beyond what is desirable, resulting in either a political backlash or a rescue effort to stabilise its gains.

Acceptance of ESG and purpose has been no different. In some respects, private equity has been slower to take these ideas seriously than public companies that are subject to more regular and extensive reporting requirements and have greater experience in managing a wide set of stakeholders. At the extreme, some in the industry are resistant to this agenda and even take pride in PE's perceived image as a 'safe space for the hard-nosed' away from the 'progressive constraints of public company existence' and 'woke capitalism' (Jenkins, 2021).

This criticism is unfair – not least because the pace of change in this space makes any assessment look out of date very quickly. The UN's Principles for Responsible Investment (PRI) observes that the number of PE and VC managers among signatories to the network has quadrupled over the past five years, for a total of 1,090 today. Disclosures have been increasing over time, irrespective of the firms' investment strategy, size, listing status or investment location (Abraham et al., 2022; Lim and Wilmer, 2022). One small but significant example of this shift is the ESG Data Convergence Project, led by CalPERS and Carlyle and joined by over 100 members, that is streamlining the private equity industry's historically fragmented approach to collecting and reporting ESG data and giving GPs and LPs a common basis on which to assess and compare the performance of portfolio companies (BCG, 2021). As these and other initiatives gain momentum, what was once a reluctant exercise in compliance or a niche product for a small minority of investors is now seen as a source of competitive advantage, informing each stage of the investment process. This extends as far as post-exit analysis with PE firms like Apollo Global Management developing tools to establish how ESG issues affected performance and how they might apply that knowledge to future investments.

A leader in integrating these considerations is EQT, the Swedish private equity house founded in 1994. In 2010 EQT was among the first in the PE industry to become a signatory to the UN-backed Principles for Responsible Investment (PRI) and, in 2020 became the first private markets firm in the world to publish a 'Statement of Purpose' and recently issued the world's first sustainability-linked bond in the sector. An ownership mindset is in EQT's DNA, partly the inheritance from the Wallenberg family, via its investment vehicle, Investor AB.[xix] Other pacesetters include Inflexion, Triton Partners and Nuveen.[xx]

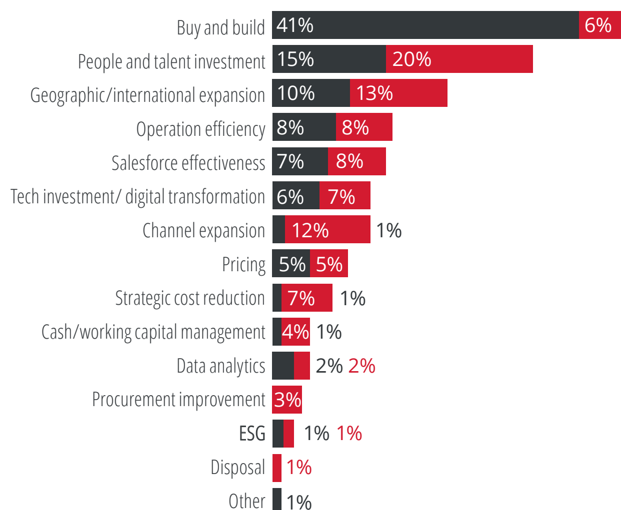
It is tempting to dismiss the likes of EQT as outliers. Some might argue that EQT's success is part of a broader institutional and cultural package – a Nordic model whose exceptionally high levels of openness and transparency make it difficult to transplant to other settings. It is no coincidence that some of EQT's early wins came in markets like Germany that has a rich industrial and stakeholderist tradition, similar to Sweden. While this is an undeniable part of the story, it is not the whole story: EQT is today a global private markets firm and practices are being adopted by peers, including some of the industry's most venerable names.[xxi]

This does not mean the process of mainstreaming ESG in private equity is complete – far from it (Bain, 2021). For better or worse, the industry remains wary of external commitments that can limit its freedom of manoeuvre and ability to develop its own targets (Klasa, 2022). For example, leading PE firms have stayed out of major initiatives such as the Glasgow Financial Alliance for Net Zero (GFANZ), the world's largest climate-finance coalition. This is even after it relaxed its insistence that members align with the UN's Race to Zero that had been introduced to ensure the rigour and impact of corporate and financial sector pledges in the face of concerns about greenwashing.

Stated more simply, ESG is not the only game in town. It must compete with other strategic priorities for management attention, mindful that spreading too thinly and trying to do everything at once are seldom a recipe for success (Frei and Morriss, 2012). KPMG (2022) finds that even as ESG plays a more important role in the investment decision making process, it is still overshadowed by other value creation levers and this situation is unlikely to change in the short to medium term *(see Figure 12)*.[xxii]

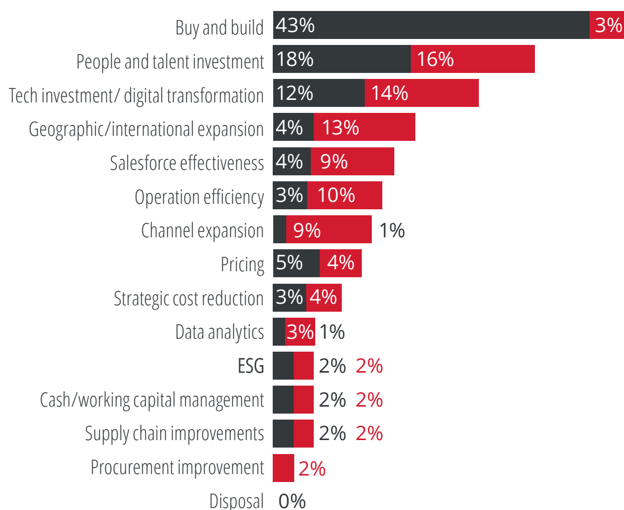
Figure 12:
Most common value creation levers to date

Buy and build and talent investment are the top two to date creation levers over the past three years.



Most common value creation levers in the future

Tech investment and digital transformation doubles in importance over next three years.



[4] Past three years [5] Next three years

Rank 1 Rank 2

Source: KPMG (2022 Market Insights Survey)

But perhaps we are looking in the wrong place if we simply equate 'doing well by doing good' with a stated commitment to ESG. Without much effort and with complete plausibility, many ESG goals can be formulated within the assumptions and casting of shareholder value to produce an equally congruent account. Because an organisation's success depends on long-term relationships with each of its stakeholders who provide valuable financial and human capital, institutional infrastructure, revenues and social and political legitimacy, there seem to be limits to how far profit maximising organisations can create value if they fail to acknowledge or treat stakeholders well.

Improving workplace safety is a case in point. It simultaneously benefits workers and is a source of value for investors through decreased downtime, fewer lawsuits, lower compensating wage differentials, increased employee morale and productivity and better chances of an IPO exit.

Consistent with this, Cohn et al. (2021) document a large, sustained decline in workplace injury rates in the US after buyouts of publicly traded companies. Annual injuries per employee fall by 0.74 to 1.00 percentage points relative to control groups or 11.1% to 15.0% of the pre-buyout mean. This is equivalent to 650,000 to 880,000 fewer injuries annually if the same improvements were replicated in all US businesses. Interestingly injury rates appear to decline more sharply at firms that were under more short-term performance pressure before buyouts, as measured by higher levels of analyst coverage, transitory institutional ownership and discretionary accruals. This raises the possibility that going private lengthens decision-making horizons, though the evidence presented here is suggestive but short of conclusive.[xxiii] Interviews link these changes to a sharper emphasis on operational execution after buyouts, with an emphasis on the 'unglamorous stuff', the nuts and bolts of setting targets, introducing scorecards and strengthening monitoring. These activities involve well-oiled reflexes that come naturally to PE firms: they can be broken down into tangible, value-driven use cases; they are low cost and they play to PE's strengths in bringing clarity and discipline to initiatives.

Workplace skills provide another example of these mutual benefits. Agrawal and Tambe (2016) find that private equity increases IT investment that imparts workers with valuable transferable skills such as data analysis and collaborative problem solving. The authors obtain detailed proprietary data from one of the largest online job search websites in the US to track the career paths of workers. The acquisition of these skills has a positive impact on workers'

long-run employability and wages even after they leave the company. The economic magnitude is large: workers once employed by a buyout target experience a 2.5-3.5% wage gain for each unit increase in IT complementary activity required by their jobs. In firms with a strong IT focus, the wage premium is estimated to be up to 13% higher. There is not much mystery to these outcomes: skills and technology are complements and firms are aware of the need to provide training to their staff if they are to realise the productivity benefits of digital technologies in full – a pattern that has recurred throughout the history of economic growth (Galor, 2022).

These dynamics can be likened to an inkblot without any explicit boundaries flowing along paths of least resistance and engrained routine. There is a high degree of persistence and predictability to this instrumental behaviour. However, this should not be interpreted as meaning that practices, even very durable ones, are set in stone. Organisations are capable of making adjacency moves – pushing the boundaries of successful practices into new territory as they move down the experience and learning curve and gain insight into what works, with each stage uncovering new opportunities to add value (Zook, 2004).

As an illustration of this forward-moving logic in action, major PE firms have begun to broaden employee ownership beyond senior executives to cover *all* workers in portfolio companies. KKR recently took the step of making its flagship $19bn North America Fund XIII the first dedicated fund to implement employee ownership across all majority-owned companies. This fund scales up an approach that it has been experimenting with for years: when KKR sold Illinois based CHI Overhead Doors, a leader in the garage door industry, to Nucor Corporation for $3bn in May 2022, it netted the company's 625 line workers, including those who drive trucks and stand on the assembly line, $175,000 in average profits. In turn, it has catalysed wider industry action. Ownership Works, a non-profit launched with the support of major financial institutions, will help companies implement broad-based equity programmes. As part of this commitment, nineteen PE firms will introduce employee ownership at a minimum of three portfolio companies by the end of 2023 with the goal of generating at least $20 billion for hundreds of thousands of new employee-owners by 2030 (Gottfried, 2022).[xxiv] Initiatives to strengthen employee engagement and loyalty are particularly appealing at a time of tightening labour markets when rising input costs, including employee turnover, have become key risks to corporate margins and industrial action is on the rise around the world (Subramanian et al., 2022).

But this same logic also implies that PE firms are unlikely to stray too far from their comfort zone. That is, in any diversification effort, organisations cannot change direction on a dime. They may 'jump' to activities close to those they are already specialised in but avoid more distant activities that require quite different assets, capabilities and frames of reference. Consider again the launch of Ownership Works. It is certainly significant relative to the industry's past record. Measured by ambition, however, it is relatively modest compared to the goals of the broader employee ownership movement. For example, some have expressed concern about the lack of transparency regarding the Ownership Works equity model – in particular the fact that equity grants will not take the form of ESOPs that come with a raft of legally mandated protections for employees (Bonham, 2022). Others point out that these initiatives are putting the cart before the horse or, at least, not embracing employee ownership in its totality. That is, a true ownership culture is not just about financial upside but about the opportunity for workers to have a voice and exercise influence over decisions (MacFarlane, 2022).

If voices in the industry do not see things this way, it is arguably because their assumptions contain a blind spot. A strict emphasis on profit maximisation, embodied by private equity, may struggle with the more ineffable, subjective and soft aspects of purpose such as employee satisfaction. Like other high-level principles of behaviour, its returns are both uncertain and distant, and consequently may be underweighted in corporate decision making relative to nearer, more measurable goals.[xxv]

There is some evidence that this is happening. Gornall et al. (2021) use employee reviews from the website Glassdoor to explore the impact of PE ownership on dimensions of job quality such as compensation, work-life balance, culture and relations with senior management. They find that job satisfaction falls across all dimensions after a PE buyout with culture and compensation showing the largest negative effects. These findings are echoed in contemporaneous work by Lambert et al. (2021) who also highlight important differences by buyout type. Public-to-private transactions again stand out: all employees, independent of their job position, express high levels of dissatisfaction after being bought out. For companies that were privately held prior to the buyout, the effects are less pronounced: the decline in satisfaction is half as large as for public-to-private transactions and only present for employees in non-managerial positions, suggesting that actions of the management team – its human resource policies, its top down approach, its caring attitude or ethical behaviour – are the main source of the problem.

Aspects of this story nonetheless leave important questions unanswered. Puzzlingly, Gornall et al. (2021) report large declines in reported satisfaction with compensation even as they find no measurable change in base pay for employees. The puzzle unravels, however, when one considers the role of risk and how it is shared within portfolio companies after buyouts. If workers are risk-averse, they will demand higher wages from firms that have a higher risk of financial distress to compensate for the potential costs of job loss and unemployment. By magnifying the risk of insolvency, leverage in buyouts strengthens these demands. To the extent that post buyout, most employees earn the same pay at what is now a riskier firm, so they will perceive themselves as underpaid relative to their new job and the risks they now bear, resulting in greater dissatisfaction. Consistent with this hypothesis, the authors find that higher leverage deals have far more negative effects on job quality, with moderate to no effect for low leverage deals. Long-tenured and lower-skilled workers and workers with limited labour market options are the most adversely affected – again supportive of the idea that buyouts revise norms of reciprocity and trust around risk sharing since these workers have the most to lose from risk either because they face the highest costs to job loss or were the main beneficiaries of the previous status quo. By contrast, highly skilled workers fare much better, though they are more likely to report deteriorations in work-life balance consistent with a faster and more challenging work environment after the completion of a buyout.

While superficially attractive, it would be wrong to conclude from this discussion that buyouts simply redistribute value from workers. Risk cuts both ways: if PE firms pass more downside risk to employees than at comparable public firms, they also give more performance pay on the upside. Gornall et al. (2021) estimate that a 1% higher deal IRR translates to 0.7% more employee incentive pay with the best performing PE deals associated with the happiest employees. None of this alters the fact that buyouts reduce satisfaction on average – indeed, buyout employee satisfaction is only higher than the average public firm benchmark for deals returning above the 74th percentile which is an undoubtedly high bar to clear. But it does point to a more nuanced middle ground than either the 'value extraction' or 'pie growing' extremes would trustingly suppose.

A limitation of this work is that it includes pecuniary factors such as compensation and benefits in definitions of employee satisfaction that can overshadow analysis of its softer dimensions. Using Great Place To Work (GPTW) data, Garternberg and Serafeim (2020) take a different approach and construct a measure of purpose based on employee beliefs in the meaning and impact of their work and clarity from management. This construct comes closer to capturing the meaning of purpose as understood in an organisational setting and has been found to predict firm performance in other studies, particularly where beliefs are held by middle management (Gartenberg et al., 2019). Analysing data from approximately 1.5 million employees, the authors find that having private equity owners is associated with 25% of a standard deviation in lower corporate purpose relative to other private firms. This difference is attributed to the contractually set and

limited lifetime of PE funds that has a dampening effect on commitment. However, the difference is most pronounced for publicly listed ownership that is associated with a 38% of a standard deviation in lower purpose. On the other hand, having long-term investors helps reverse this public market penalty: a one standard deviation increase in long-term investors is associated with 9% of a standard deviation in greater corporate purpose.

The golden thread running through all these cases – both positive and negative – is that stakeholders are a means to an end rather than the end itself. In many cases, the implications of this distinction are trivial but it delimits and exposes some of the harder edges of shareholder value. Even if a party acknowledges the need to invest in stakeholders, it has strong incentives to do so to the minimum extent necessary to enhance shareholder value. Spaenjers and Steiner (2021) highlight these effects in the hotel industry. They find that an important lever for increasing profitability in PE owned hotels is cutting labour expenses, especially in rooms departments. These cuts lower service quality but not to the degree that they harm average daily rates or occupancy. One explanation is that poorer guest experience ratings are driven largely by changes at the top of the distribution – more four-star ratings and fewer five-star ratings, meaning that the decline in quality is subtle and unlikely to have a discernible effect on guests' behaviour beyond an abstract irritation. It illustrates how actions are carefully chosen to balance costs and benefits, trading off customer satisfaction for immediate financial goals and stretching this equation as far as it is economically rational without cutting too close to the bone.

As knotty as these cases are, they perhaps present too straightforward a picture. In each case, trade-offs exist between shareholders and stakeholders but their respective interests sufficiently overlap that a balancing and apportioning of mutual benefits, however messy, is still possible. In practice, some of the most pressing economic and social problems animating current debates on corporate purpose involve situations that do not offer win-win choices but cleavages between shareholders and stakeholders that run deep and wide. Here there is nothing in the logic of shareholder value or its rhetorically inviting offshoots that prevents firms from taking actions that are privately profitable but socially costly (Shive and Forster, 2020). The question then becomes: how large is this issue and which types of activities display greater (or lesser) alignment between shareholder preferences and broader stakeholder interests – a discussion to which we turn now.

V. Externalities, sector considerations and *private equity as capitalism in high gear?*

> *"You tend to find if you interview people within these companies they say the experience of going through private equity ownership is: it's sort of, some people like it, some people don't, but what you tend to hear is 'There's been quite a lot of change. It's stretched me in ways that I didn't understand, I didn't think we needed to do or we wanted to do"* — **Peter Deming, Managing Director, Warburg Pincus**

One of the more revealing lenses through which to view heterogeneity in private equity focuses on sector characteristics and market structure. PE owned companies that operate in markets with high levels of competition and price elasticity of demand, minimal government subsidies and transparency around product quality, tend to yield superior outcomes for stakeholders. In contrast, private equity investment in sectors with relatively low competition, information frictions and the presence of government subsidy can reduce stakeholder welfare.

By implication, the closer sectors approximate the ideal of perfect competition, the stronger the case for private equity ownership. Bernstein and Sheen (2016) obtain restaurant health inspection records from the US Food and Drug Administration (FDA) and find that restaurants become cleaner, safer and better maintained after being bought out. Consistent with a causal interpretation, improvements are larger in directly owned stores than in franchised locations – twin restaurants belonging to the same chain over which PE firms have limited control and influence. These operational practices matter: the reduction in health violations is associated with improved customer ratings and restaurant profitability in the wider literature (Jin and Leslie, 2003; Luca, 2016).

Fracassi et al. (2022) use granular retail scanner data to compare product varieties and prices of consumer products sold by PE owned and non PE owned businesses in retail stores. The data is extremely detailed extending down to the individual product and store level – say sales of a small tin of French-style green beans in a particular supermarket in Chicago. It allows the authors to use literal store shelf neighbours as counterfactuals that mitigate biases from composition and location effects. The authors find that after a buyout, sales rise by 50% compared with similar brands that are not bought out. This is achieved through the launch of new products and geographical expansion to new store locations rather than price hikes that increase by only 1% relative to competitors. The study illustrates the myriad ways in which PE funds steer businesses through a process of rapid process improvement to unlock new sources of value – in this case, focusing on product categories popular among high-income consumers, strategically adjusting prices to economic conditions and doubling down on strong positions in fragmented markets. Interestingly, results are driven almost exclusively by private-to-private deals – consistent with the evidence presented in section II. By contrast, public targets raise prices by 2% and see revenues fall by 6%, echoing the earlier results in Chevalier's study of leveraged supermarket buyouts (Chevalier, 1995).

By contrast, a more ambiguous picture emerges the further markets move away from a Nirvana world of minimal information and transaction costs. Gupta et al. (2021) investigate the effects of PE ownership on the quality of care for short-stay Medicare patients at for-profit nursing homes. They find that quality decreases in homes acquired in buyouts: going to a PE owned facility increases 90-day mortality by about 10% for short-stay patients, implying 20,150 lives lost due to PE ownership of nursing homes over the sample period.[xxvi]

The authors also report declines in front line staff and compliance with regulatory standards of care. This is accompanied by the increased prescription of antipsychotic medications that may be a substitution response to lower nurse availability, notwithstanding the fact that use of antipsychotics is strongly discouraged in the elderly. At the same time, taxpayer spending for each patient stay increases by 11%, suggesting that private equity ownership decreases productivity, as measured by proxies for quality output per dollar spent. Finally, with the reduction in nursing staff, there is a shift in operating costs towards non-patient care items like monitoring fees, interest and lease payments following the sale of real estate which are profit drivers for PE funds and explain how, along with leverage, they can generate potentially high returns even in the context of thin margins.[xxvii]

Structural features of the healthcare sector contribute to the divergence between the interests of PE investors and other stakeholders (Brown et al., 2021). In the US, healthcare is highly regulated, where revenues of healthcare providers depend on subsidies such as fee-for-service and the reimbursement rates accepted by either government payers or private insurers. Since most consumers do not fully pay out of pocket, incentives for providers to compete on price are weaker. Finally, medical relationships are premised on, and pervaded by, informational inequalities that make it difficult for patients to assess the quality of care and compare it with available alternatives. Many of these patients are also among the most vulnerable in society and likely to face geographic and other barriers that further reduce choice.

Education, though not a perfect parallel, is affected by similar forces. In the US, the expansion of federal student loan programmes since the early 1990s has created opportunities to extract value from other stakeholders. This boom has been underwritten by a guarantee subsidy under which the government and taxpayer cover the outstanding balance of any loans in the event of default. Due to this generous support, for-profit schools can market zero upfront costs to low-income students who, in turn, are insulated from the full costs of their choices. Moreover, students will not know the quality or value of their degree until after they graduate or indeed many years after entering the labour market. They also typically purchase a degree programme only once, further increasing the appeal of reneging on implicit contracts. The elusive, murky and delayed nature of evaluation is compounded by the complex set of motivations that influence choices about university such as social status aspirations and a faith in the emancipatory power of education and the relation between merit and reward that means investment decisions are made with the heart as much as with the head.

Such conditions can create conflicts between shareholders and stakeholders. Eaton et al. (2020) find that private equity involvement in American higher education has led to higher profits but worse student outcomes – lower education inputs, graduation rates, loan repayment rates and earnings among graduates. Specifically private equity owned schools are more aggressive in exploiting increases in student loan borrowing limits to raise tuition than other institutions, encouraging higher levels of borrowing. While loan repayment rates are lower, schools are protected because of government loan guarantees. PE owned schools also pursue more aggressive marketing and recruiting strategies to expand enrolment. On average, they employ nearly twice as large a share of their employees in sales than do other for-profit schools, straining teaching budgets and instruction quality. In his book *Bankers in the Ivory Tower*, Eaton describes some of the confusing marketing tactics employed by these schools – one popular practice was for parent companies to keep multiple brands providing exactly the same degree, sometimes even within the same geographical market to hedge against the risks of poor educational practices in any one subdivision damaging the firm's wider reputation.

Nonetheless, looking at behaviour at the wrong granularity can lead to mistaken diagnoses about what is going on and poorly targeted policy responses. For example, we commonly speak about the healthcare sector in toto but, in practice, it encompasses many different activities, each with its own characteristics. For example, the effects of private equity ownership might look quite different in dermatology or optometry where there has also been significant PE activity but it operates in a more transparent and competitive market (Braun et al., 2021). Even within heavily regulated and subsidised industries, it is important to deal with matters on a case-by-case basis. In their study of the banking sector, Johnston-Ross et al. (2021) find that PE firms played a constructive role in the failed bank resolution process in the aftermath of the 2008 crisis, providing much needed capital that helped fill the gaps of a weak banking sector at a time when the natural potential acquirers – local banks – were themselves in deep trouble and teetering on the brink of bankruptcy. The fact that interests were better aligned in this case is interesting. One possibility is that private equity firms were particularly well-placed to act relative to other parties: it is plausible that they had a higher risk appetite than other acquirers; access to more stable funding at a time of capital scarcity and more specialised skills in relevant areas such as turnaround management and distressed assets. Whatever the reason, the unique circumstances of the financial crisis caution against broad extrapolation, but the case does raise the question of whether there are particular factors that shape the degree of misalignment between private equity and stakeholder interests in regulated industries and what, if anything, policy can do to address them.

As with most things, there is a tendency to treat cases as black and white rather than see the complex shades of grey. They do not afford us the luxury of falling neatly or predictably on one side of the ledger (or other). Thus, in practice, both the 'good' and 'bad' sides of private equity can be present in a given transaction. The world of journalism provides a fascinating example of these contradictory forces at work. Historically an industry stewarded by wealthy families and patricians, today about half of US daily newspapers are controlled by private equity, hedge funds and other investment groups. Ewens et al. (2021) examine the impact of these changes on a range of financial, media and political outcomes. The picture that emerges is complex: on the one hand, there is a decline in local news and shift in the composition of news towards national topics. This is a response to the underlying economics of the media business: there is a fixed cost to producing news reporting, but once an article exists it can be syndicated across many newspapers at a very low marginal cost and stories with wider appeal are most suitable for syndication. The authors link this changing focus to falls in participation in local elections, consistent with local newspaper content being a public good and valuable for civic engagement. On the other hand, they show that private equity funds improve the survival prospects of newspapers. Post buyout, newspapers are accompanied by higher digital subscriptions, suggesting increased investment in digital platforms that permits them to transition to a more resilient business model.

Finally, we should be careful not to isolate findings and effects from their larger context. Consider private equity's reputation for ruthlessly laying off workers – perhaps best articulated by Wall Street Journal reporter Susan Faludi who won the Pulitzer Prize in 1991 for her trenchant and traumatic portrait of how Safeway employees were treated by private equity – many of whom suffered lay-offs, family upheaval and, in some cases, suicide. These observations are not just anecdotal: research shows that many buyouts are followed by a decline in employment and increased turnover. These outcomes are undoubtedly painful and serious but understanding their context is also important. After all, it is entirely conceivable that some buyout targets were in urgent need of restructuring and retrenchment and doing so forestalled deeper pain down the line or that job losses after certain types of buyouts were crucial for realising post-buyout productivity gains that benefited society at large.

Discerning the precise balance of these effects – their prevalence and magnitude – is an empirical question. But once we acknowledge and account for them, we begin to see fewer cases of pure rent extraction. In their study of Swedish private equity buyouts, Olsson and Tag (2017) find that layoffs are concentrated in the middle of the wage distribution, namely clerical and administrative work. This is consistent with a productivity based account with firms taking advantage of automation and offshoring production that have a comparative advantage in these types of routine tasks – and accelerating the reallocation of jobs, workers and capital to their most productive uses. In an analogous way, Antoni et al. (2019) and Garcia-Gomez et al. (2020) use individual-level administrative data and show that the costs of buyouts fall disproportionately on lower productivity workers such as older workers and workers with underlying health conditions. In some cases, these costs are less a function of these workers being laid off at a higher rate than other workers than their subsequent difficulties in finding new employment. In other cases, they reflect a more explicit strategy to identify and lay off less productive employees as in Garcia-Gomez et al. (2020) where losses of income and employment are concentrated in employees in poorer health.

Thus seen, perhaps a more accurate characterisation is that PE ownership accelerates and magnifies underlying market forces. The historical record is unflinching on this point: the transition from feudalism to market capitalism that provided the foundation for modern economic growth has brought increasing dynamism where the tasks that workers perform are in perpetual flux. Insofar as these changes can entail sharp, often disruptive, drops in individuals' standard of living, we should not be surprised when private equity also produces losers. But insofar as they can be understood through the lens of market forces, we should also expect them to play out in more benign ways, as illustrated in Agrawal and Tambe (2016) where buyouts increase IT investment and impart workers with valuable transferrable skills.

The larger point is that many of these issues are more fundamental than implied by critiques of private equity. In an era of widespread anxiety about the future of employment and economic inequality but also anaemic productivity growth, they should be addressed in a more comprehensive manner - through social welfare programmes that insure against the risks of unemployment, skills and education policies that boost workers' employability and removal of labour market frictions that facilitate the adjustment to trade and technological shocks (Blanchard and Rodrik, 2021). The more deep-seated we think the drivers of job displacement are, the more radical the surgery needed. Otherwise, policymakers risk treating symptoms rather than causes that will almost certainly do more harm than good. In their study, Garcia-Gomez et al. (2022) find that half of the negative impact of buyouts is cushioned by social transfers and this buffer is larger for employees in poor health. The setting for the study – the Netherlands with its relatively generous social safety net – is nonetheless telling and points to the scale of the challenge facing policymakers elsewhere.

VI. Aligning shareholder preferences with the broader public interest: *the role of regulation and LPs*

"If you have a clear sense of Purpose, don't fight the regulators. Use it to improve the quality of what you are doing. Deal with it at an industry level"
— Sir Michael Rake

"What PE has seen in vet practices is probably more of a financial trick: I could buy a practice for five times, but because of a group value, it is worth ten. The real test will be over time; is it a financial trick or are you investing to make them better businesses?"
— Peter Pritchard, CEO of Pets at Home (until May 2022)

"The industry relies upon large flows of money from large institutions, to be anything like its current size. If those large institutions want to have ESG and corporate governance, purpose, whatever, then the private equity industry will have to and will respond. It will not do so necessarily out of any firm beliefs that this is a good idea but a firm belief that it's profitable to do so they will take it forward"
— Jon Moulton

"On the one hand, our LPs would like to see relatively simple ways of portraying how things are. On the other, management teams get irritated if you try to make it too simple. One of the problems is reducing things to a simplistic approach. For example, it does not make sense to talk about diversity unless you are talking about what kind of business you are doing, just as if you only focus on earnings per share, you will have unintended consequences somewhere else"
— Andrea Ponti, Managing Partner and Founder of GHO Capital

"Part of the opportunity of having a distinct impact fund is to be able to really drive the experimentation as our lighthouse fund for the rest of the business but also have one that offers climate and health investment opportunities, which our clients increasingly want, where scaling or transforming social or environmental business solutions specific around sustainable investment is the primary investment objective"
— Sophie Walker, Head of Sustainability for Private Capital Europe & North America, EQT

The heavy lifting of aligning private equity with the public interest is ultimately the domain of policy rather than managerial discretion and the clarion call of stakeholderism (Glaeser and Shleifer, 2003). Where the unilateral decision to act purposefully has transitional costs that are not borne by competitors, only coordinated action, such as regulation, can safeguard purpose at an economy-wide level.

The good news is that any improvements in the policy and regulatory environment tend to be amplified under the high-powered incentives of private equity ownership.

This can be seen in Bellon (2020) who uses satellite imaging and administrative data for fracking wells to examine the impact of private equity ownership on environmental outcomes. On average, PE ownership leads to a 70% reduction in the use of toxic chemicals and a 50% reduction in satellite-based measures of CO2 emissions. However, this headline figure masks very different trajectories for environmental outcomes in strong and weak regulatory settings. PE-backed firms actually increase pollution in locations and periods where environmental liability risk is low, such as when the Trump administration rescinded an Obama era rule governing hydraulic fracturing on public land, highlighting the outsized role that policy plays in remedying corporate externalities.

Regulation can help steer private equity towards the high road even in market environments that are ostensibly less hospitable to purpose. Gandhi et al. (2021) find that PE owned nursing homes are more sensitive to local market competition than non PE counterparts. Due to this heightened sensitivity, patients benefit from PE ownership in competitive markets but are harmed in concentrated ones. They also find that, after the introduction of the Five Star System that allowed consumers to quickly and easily assess the quality of facilities, PE owned facilities in competitive markets were more active in increasing staffing expenditure and shifting it towards higher skilled nurses as well as investing in other quality improvements covered by these ratings.

Finally, regulation can alter behaviour even where PE-owned firms are not the focus of attention for policymakers: Abraham et al. (2022) find that ESG disclosure mandates in public markets can have a positive spillover effect for voluntary disclosures among PE firms that, in turn, can have a meaningful effect on purposeful behaviour. One possibility is that as PE firms compete for the capital of investors that can alternatively invest in public markets, they respond to investors' awareness of ESG disclosures prompted by regulatory mandates by stepping up their own ESG disclosures.[xxviii]

A stiff dose of realism is nonetheless essential. Against such promise, we must weigh the potential costs of intervention. Just because a problem exists does not mean that a new regulation will solve it – and even when a solution exists, enforcement bodies may lack the capacity to monitor and detect regulatory violations as a result of underfunding, restrictive human resource practices and other constraints (Lewis, 2018).

Paul David's metaphor of the Blind Giant lays bare the perils of overactive regulation: policymakers have the greatest opportunity to shape market structures and trajectories at precisely the time when they know least about what should be done (David, 1986). Attempting to regulate markets ensnared in complexity can lead to unintended consequences, exacerbating distortions rather than eliminating them because interventions add even more complexity – in the process, creating new loopholes to transfer wealth from stakeholders.[xxix] This leaves us with the larger question of how public and private actors who both have imperfect information, can come together to solve problems, each side learning about the opportunities and constraints faced by the other to ensure that regulation is fit-for-purpose. These issues that touch on basic questions of institutional design will no doubt remain at the heart of a public discussion that extends well beyond PE (Nesta, 2019; Sabel and Victor, 2022; Allen et al., 2022).

Even under the most optimistic scenario, there may be limits to how far regulators can go to guarantee the types of competitive structures

that best align private equity and stakeholder interests. An analogy with the natural world that is supposedly modelled on hard Darwinian truths and provides inspiration for thinking about competition in economic and social systems is instructive here. In his fascinating essay *Good Enough*, Daniel Milo (2019) argues that nature is very different from the 'penny grudging, extravagance punishing accountant' that mercilessly punishes the excess, inertia, mediocrity and failure that is featured in many accounts. Many paths to survival – genetic drift, geographic isolation and founder effects – slip undetected under natural selection's radar such that nature can be remarkably tolerant of inefficiency. The broader lesson is that policymakers operate in a second-best environment of their own and that proposed approaches to ownership need to be robust to these conditions. If the ideal of strong competition is, at times, more honoured in the breach than the observance, then the goal of promoting purpose may be better served by using simpler, not complex decision rules. That is, if purpose is to have teeth, then it might be advisable to demand less of it, and to ensure that the lesser demands are enforceable (Haldane, 2012).

This observation takes on additional significance against the backdrop of buy and build strategies. Add-on transactions today account for over 70% of PE companies' deal volume – up from 40% in 2004 – a trend that is illustrated by the rapid consolidation of the veterinarian industry in the UK where the share of independent practices has tumbled from 83% in 2013 to 45% in 2021 and PE backed groups like IVC, VetPartners and Medivet have built up a large presence. Similar trends have taken place in the US where local businesses of every stripe – from car washes to emergency room hospitals – have been rolled up (Vandevelde, 2022). There are obvious efficiency benefits to horizontal consolidation in what are often fragmented cottage industries but there are also questions about what this means for competition and market power that the literature suggests induces private equity to work with the grain of wider policy goals.

This matters because add-on acquisitions are often small enough to fall below the threshold for antitrust review in markets like the US. This gives regulators less time to scrutinise the competitive effects of deals prior to completion, potentially catching them off guard when a company has secured a dominant position. Recent work studying the dialysis industry finds that proposed acquisitions of facilities are blocked more than 80% of the time when part of reportable mergers, but less than 2% of the time when part of exempt ones as a result of their size. This is notwithstanding the fact that the resulting market structure is found to reduce facility quality and compromise patient health (Wollmann, 2020). Kepler et al. (2021) provide related evidence that a disproportionate number of deals fall just below reporting thresholds, suggesting that deals are carefully structured to evade scrutiny. Not only do acquiring firms benefit from such stealth acquisitions but so do their industry rivals who are able to take advantage of softer product market competition, limiting output and raising prices. These findings are not unique to private equity, but they should be taken into account when assessing its impact since buy and build – the preferred strategy for many PE firms – increases market concentration in small, steady steps and along with it the risk of monopoly by a thousand cuts. Competition authorities in the US have signalled their intention to investigate this behaviour along with practices such as the use of interlocking directorates in which the same individuals or entities have board seats at competing businesses (Palma and Fontanella-Khan, 2022; Nylen and Shields, 2022).

Having the right policy ideas and instruments is a necessary, albeit insufficient condition for dealing with corporate externalities. Political will is also important. Consider the choice of financing. Most countries' tax systems favour debt over equity, allowing debt interest payments, but not the cost of equity, to be treated as a tax-deductible expense (Mirrlees et al., 2011; De Mooij, 2012).

This bias is a significant driver of leverage that increases the risk of bankruptcy that, as we have seen, can have negative spillovers for stakeholders, especially in the context of limited liability (Heider and Ljungqvist, 2015; Dallari et al., 2018). It can also lead parties to base financing decisions on tax and cost

avoidance considerations with knock-on effects for the public purse. Cohn et al. (2014) use US federal corporate tax return data and find that the high leverage of PE owned companies persists and even drifts higher several years after the buyout, implying that private equity ownership constitutes a one-time permanent change in the capital structure of the companies. Higher leverage creates value for shareholders by increasing the present value of interest tax shields while reducing corporate tax revenues from PE portfolio companies. Changes in tax revenues can have negative consequences for the provision of local public goods, even after accounting for the fact that PE-owned firms often increase investments in physical and human capital, potentially creating a larger tax base (Olbert and Severin, 2021).[xxx]

Where there is political will, there may be a way. But between inertia, industry opposition and the simple fact that the benefits of reform tend to be diffuse, but its costs are concentrated in a smaller group, turning it into concrete action is a perennial challenge, as the limited progress made on equalising the treatment of debt and equity illustrates (Faccio and Hsu, 2017).

Policymakers require broad shoulders to safeguard well-functioning markets but this does not mean that they need or should carry all the load. GPs are also under increasing pressure from LPs to incorporate ESG into their investment and portfolio construction process. The industry is facing greater commercial competition to win mandates, and as a result, funds without any ESG considerations are becoming harder to sell, although the degree varies by jurisdiction. Many LPs are putting their money where their mouths are by investing in impact funds: Barber et al. (2021) estimate that LPs are prepared to accept 2.5-3.7 ppts lower IRRs *ex ante* for impact funds, relative to comparable non-impact funds. They are also far more willing to walk away from an investment if it poses an ESG concern – a commitment that extends beyond the risk or fear of negative headlines (Bain, 2022). These pressures are keenly felt: according to Prequin, nearly three-quarters of investors (72%) believe fund managers are adopting ESG policies because of pressure from existing and prospective LPs (Yeomans, 2022).

This is matched by a growing appetite for long-dated PE funds. The standard model for a private equity fund has traditionally followed a ten year model with the capital deployed through the first half of the life and exits often being a precondition for raising the next fund, meaning that holding periods rarely exceed five years. These structures have been curiously resistant to change, though there is no reason to think that they are once and for all inviolate. As Ivashina and Lerner observe, many were forged in the heat of the moment, borrowed from other fields such as limited partnerships rather than the product of some elaborate design. Thus, the relatively short life of these structures may not be appropriate for investments, tied to secular tailwinds, that take longer to show results or involve development plans with higher regulatory, technology and market risk. Drawing on the experience of the venture capital industry where similar arrangements prevail, Lerner and Nanda (2020) find that investments are concentrated in a narrow band of technology.[xxxi] In turn, they may force investors to divest prized assets at the wrong time, say, when the market is in a trough or before the company has realised its full potential – not to mention the transaction costs, such as taxes and consultant fees, associated with buying and selling businesses.

As the PE industry has strained at the confines of the 10 year fund, so investors have found creative ways to extend the holding horizon for funds through GP-led secondary transactions, though these workarounds bring their own challenges, notably the potential conflict of interest arising from the GP's position as both seller and buyer. More fundamentally, several large PE firms, including CVC, Carlyle Group and Blackstone have been launching buyout funds with holding periods as long as 15 years. Interestingly some industry stalwarts see in this trend a better version of private equity – KKR co-founder Henry Kravis once described Berkshire Hathaway's decades-long buy-and-hold style as 'the perfect private equity model' (Gottfried, 2019). Asset owners such as Wellcome Trust, the medical research endowment, have embraced these structures due to high pricing and scarcity of assets. For some, this is a case of better the devil you know: it is preferable to pay a high

price for a company that you know than for one that you don't know.

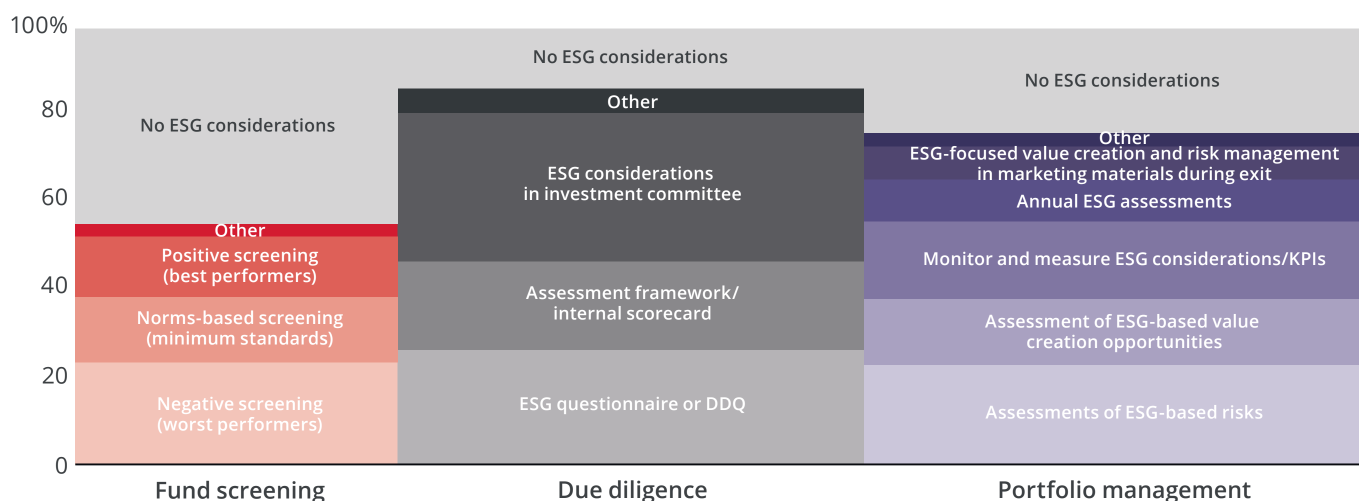
Whether this trend gains momentum remains to be seen. After all, mandatory exits provide an objective and unvarnished yardstick of a fund's performance. Investors may reasonably worry that if they give funds to a below par PE group for a long period, they will be stuck paying fees until the very end for very limited returns. The risk of gambling for resurrection and other opportunistic behaviour may also increase as the resolution of these questions is pushed further into the future in the absence of reputational and cooperative relations between GPs and LPs.

Progress remains partial, fragile and hard won. There is a clear geographical bifurcation in ESG integration with rates of adoption higher among European LPs than counterparts in the US, albeit with some exceptions. This may reflect the fact that European LPs (70%) are much more likely to believe that strong ESG performance increases valuation premia than North American LPs (30%) (Bain, 2022). But even among European LPs, levels of sophistication and understanding can vary markedly: while some LPs are engaging thoughtfully with their GPs on these questions, many still adopt a box-ticking mindset to the fund investment process. Among LPs that consider ESG initiatives during fund screening, Bain (2022b) finds that the vast majority (66%) use these considerations as part of negative screening with its attendant inefficiencies *(see Figure 13)*. The widest adoption of ESG considerations occurs during due diligence but it is often process-oriented and backward-looking, providing little guidance to how GPs will address future performance or purpose risks. Once money is committed, there is a belief that many LPs shift their attention to returns and take an interest in ESG and purpose only if they believe it is not hurting returns. Consistent with this belief, Bain (2022) reports that fewer than 20% of LPs said they ask their GPs for ESG reporting based on key performance indicators. In part, LPs may be reluctant to press GPs on these issues for fear of rocking the boat and getting shut out of future investment opportunities. In other cases, LPs may not ask because they know that GPs are not in a position to provide relevant ESG performance data.[xxxii]

One promising response to these challenges is to rethink the governance of funds and embed ESG and purpose more explicitly in them. Geczy et al. (2021) study the LP contracts of PE impact funds and find that they have introduced sophisticated mechanisms to deal with the inherent uncertainty around the nature and performance outcomes of impact.

What is most interesting about these mechanisms is what they don't do: very few funds tie compensation to impact and most retain traditional financial incentives. This runs counter to the growing consensus that executives' short and long-term compensation plans should incorporate precise ESG metrics, as exemplified by companies like Diageo. According to theories of multitasking, combining strong rewards for dollars with weak rewards for impact is an accident waiting to happen, encouraging agents to spend too much time on rewarded activities and not enough on other desired activities – in this case impact. Nonetheless, the authors show that impact funds solve for this incompleteness by giving investors greater voice in, and oversight of, key fund decisions. Elements of participatory governance include investment approval, guaranteed seats on advisory committees, information and reporting rights, access and inspection rights, auditing rights and access to portfolio companies.

Figure 13: ESG considerations across indirect/fund private investments



Notes: DDQ is due diligence questionnaire; ESG is environmental, social, and corporate governance; Q) Which of the following, if any does your organization consider ESG for in the indirect/fund private investment process? Select as many as apply; Q) To what extent does your organization consider ESG in fund screening? Select as many as apply but note that screening definitions are from UNPRI's introduction to Responsible Investment; Q) To what extent does your organization consider ESG in due diligence? Select as many as apply; Q) What does your organization expect GPs to consider as part of their portfolio management activities? Select as many as apply (n=103).

Source: Bain (2022) based on ILPA-Bain ESG Survey data

This allows LPs to implement impact goals dynamically, 'braiding' what they learn from monitoring GPs' behaviour, including the informal components of contract performance such as GPs' willingness to work towards joint goals, into the funds' operational decisions, thus curbing the distortionary effects of rewarding only financial performance (Gilson et al., 2010).[xxxiii]

GPs have tended to skate over the deeper governance underpinnings of their relations with LPs. As Ivashina and Lerner (2019) observe "Not only do investors have very modest control as limited partners, but exercising even these rights can be painful".[xxxiv] These issues may become harder to ignore as investors attempt to implement purpose in a second best environment due to heightened uncertainty and other distortions – one where simple but seductive fixes such as tying compensation to ESG metrics are unlikely to work and may indeed be counterproductive. The world of impact investing holds out useful lessons in how the private capital model and even the asset owner-asset manager relationship more generally might be refined to support these wider goals.

Getting all this right and ensuring that investors provide governance to funds is not easy. LPs require considerable skill and effort to identify the best managers, benchmark returns and then engage effectively on matters of performance and purpose. Korteweg and Sorensen (2017) find high long-term persistence in performance but little investable persistence, meaning that it is difficult for investors to identify top PE firms by relying only on statistical measures of performance. Rather LPs must leverage other sources of information about PE firms and their past funds such as their internal organisation and culture, partner attributes, compensation structure, alignment of interests, deal sourcing and integration of ESG. As this information is difficult to collect and transmit, returns to LP skill are likely to remain high. In line with this observation, Cavagnaro et al. (2019) find that some LPs consistently outperform with a one standard deviation increase in skill associated with a 1-2% increase in annual returns.[xxxv] This raises important questions both for LPs, particularly non-profit or public institutions that may lack the resources and networks of other asset owners to successfully access and evaluate investments, and

for rising calls to 'democratise' private equity by expanding retail access to private markets where liquidity, validation and transparency issues add to the importance of manager selection.

Like 'Advancing Purpose', this analysis endorses an ecosystem approach to purpose. This is a challenging view for policymakers, who – from necessity and expediency – often focus on one component of capital markets in isolation and commentators who view public and private equity as two distinct, and rival, forms of economic governance. Even if companies are opting to finance themselves differently to the way they have done in the past, it does not mean that public markets are obsolete. Indeed, it is arguable that the purpose in private equity cannot flourish without healthy public markets. Bernstein (2022) makes this point forcefully. While privately held firms have considerable advantages when it comes to investing in ambitious and novel projects, they face a higher cost of capital that can eventually become a drag on growth. Publicly listed firms, by contrast, benefit from a lower cost of capital that is well aligned with the needs of commercialisation and profitability but they are less equipped to undertake risky investments with the highest potential payoffs. Life cycle effects may also explain why the relative value of hands-on monitoring varies at different stages in a firm's growth with implications for the optimal role of private and public markets (Israelsen et al., 2022). Understanding these patterns – and the critical moments when performance and purpose needs tend to shift – can help policymakers think about how to support the ecosystem at each stage for its sustained success.

Arguably, these complementarities run deeper still. Public equity markets provide an incentive for PE firms to make operational improvements, in the hope of selling their investments through the IPO markets and exiting them at a hefty multiple. This can be seen most clearly in the venture capital space which has been associated with some of the most high-growth and influential companies in the world. Notably, the high share of VC activity in countries like the US and UK may be attributable to the existence of a vibrant IPO market – a relationship that may conversely explain the relative immaturity of VC markets in more bank-oriented systems such as Germany and Japan. More subtly, concerns about the accountability of particular businesses or ownership models may increase generalised distrust towards markets at considerable cost to the economy and society (Aghion et al., 2008).

The logic of this mutual dependence implies that when one part of the ecosystem is weak, it is not made stronger by strengthening the other parts. Purpose is limited by the ecosystem's weakest subunit, or 'link'. Because of this dynamic, relatively small frictions can multiply up to yield large distortions – much like the way in which the failure of the rubber O-ring in the space shuttle Challenger's booster engine ultimately doomed the entire mission. It also implies that when each part is managed independently, the ecosystem can get stuck in a suboptimal state. In this regard, some commentators identify the widening regulatory gap between public and private equity markets – reflected, among other things, in divergent transparency and disclosure requirements – as a source of potential instability (Morris and Phalippou, 2020). This issue merits further investigation.

Conclusions

Just over 30 years ago, Michael Jensen predicted that private equity would 'eclipse' the public corporation. His pronouncement has been partly vindicated: one of the most striking developments in finance in the 21st Century has been the growth of private capital markets. Unlisted companies are no longer viewed as the poor relation of their quoted siblings.

As with many economic issues that have distributional effects, there has been a dialogue of the deaf between critics and supporters of private equity. Neither side has heard what the other side has had to say and the tone of the debate has become increasingly bitter and accusatory. This polarisation is not a good basis for policy at the best of times; in an environment in which policymakers need to ignite growth to address critical economic and social needs, it is particularly disabling.

- **A key message from this paper is that private equity ownership is not the negative force that its critics depict:** if it did not add value in the broadest sense of the term, then from a simple Darwinist perspective, it would not have reached its current size. In many cases, private equity through the close link between ownership and control has proved to be a remarkably effective vehicle for enacting positive change. This observation resonates at a time when there are calls to rein in investing based on ESG and purpose principles. It is not necessary to accept every aspect of these criticisms to recognise that reliance on ESG ratings and other practices has not delivered the intended results. This is not surprising: metrics imitate science but are closer to art and can lead to a suspension of critical judgment, stripping information of vital context, meaning and history and obfuscating the underlying drivers of a company's growth and competitive advantages.
- It is also recognised that **investing successfully in ESG and purpose takes more than just rules-based exclusions** such as negative screening and divestment. In cases where companies are highly cash flow generative and purpose-led investors make up only a small fraction of investors, divestment is unlikely to impact the company's ability to do business – not to mention that it denies investors the opportunity to engage with the companies that need it most or have credible transition plans in place. The basic element of control and high-powered incentives that accompany private equity ownership, in this regard, are highly appealing.
- But these observations should not be blind to the limitations of buyouts as an engine of purpose. Our understanding of private equity, as a whole, is still partial and incomplete: even something as seemingly straightforward as the documented outperformance of private equity over public equity in terms of shareholder returns remains hotly contested, given that it also carries more risk when adjusting for illiquidity, firm size, less frequent performance reporting and embedded leverage (Stafford, 2022). **Perhaps the most important insight to emerge from this paper is that private equity is not a stable object, indivisible and irreducible but a heterogeneous universe.** One implication is that private equity ownership is unlikely to be suited to all firms at all times, making it important to understand the conditions under which private equity is more likely to create long-term value for society. This is not a criticism of private equity *per se*, rather a criticism of overconfidence in its blanket application.

- **The heterogeneity of private equity has been obscured by the tendency to treat private equity as a distinct form of ownership rather than a more extreme form of shareholder capitalism with all its strengths and weaknesses** – what Brown et al. (2020) call **'capitalism in high gear'**. More pointedly, John Kay observes that private equity 'is very good at its best and very bad at its worst' (Wiggins et al., 2021). Which is to say that the alignment between shareholder preferences and the broader public interest cannot be taken for granted or wished away by appeals to corporate purpose. It is brittle and needs to be cultivated and protected.
- The good news is that the broader terrain on which skirmishes over purpose and ESG are fought are increasingly favourable. **Trends such as climate and demographic change are shifting behaviours and attitudes with customers, employees and investors today expecting much more from the companies with which they do business.** This is reinforced by technology, social media and new sources of data that have made the actions of companies more transparent, deepening accountability and raising the reputational costs of corporate misconduct. It will take a brave private equity investor to bet against these trends, if only for the fact that public markets are required to care about these issues and private equity still relies on public markets for a successful exit. Even the development of alternative exit mechanisms is unlikely to alter this role or calculation. For example, private capital secondaries markets have been useful in creating liquidity in an inherently illiquid market but they remain highly cyclical while secondary deals can command steep discounts relative to a public market exit.
- **It also underscores the importance of a sound regulatory underpinning that aligns incentives between private equity and public interests.** Policymakers will need to take care that touted cures are not worse than the ailments they are meant to treat. Where this is difficult or not possible, they may need to treat private equity like a plane that is unsafe at the highest altitudes but whose flight is acceptably steady closer to land. They will also need to be mindful of the subtle interplay of public and private equity markets and ensure that interventions are coordinated rather than managed in isolation. Finally, they will also need to pay attention to institutions for social insurance to manage the risks arising from economic dynamism.
- Talk about the eclipse of the public corporation lends itself to a rather triumphalist and unidirectional account. But any impression of neat or steady progress is misleading. **The private equity industry has experienced acute periods of expansion and contraction over the past three decades – one wave that peaked at the end of the 1980s and another that ended with the global financial crisis of 2008**. In each case, the expansion of the credit cycle saw increased fundraising and competition for deals that such fundraising created. This, in turn, put pressure on valuations that fed into immediate returns and into ever larger fundraising ability which put further pressure on valuations.

- **Today the industry is confronting similar pressures but is doing so against the backdrop of a higher cost of capital regime, potentially stickier inflation and the risk of slower earnings growth.** These conditions are new to many investors, not least the private equity industry whose growth has coincided with a secular decline in interest rates. As the credit tide goes out, so those private equity funds that built returns on a thin foundation of easy money will have fewer places to hide, giving rise to winners and losers. A higher interest rate environment may also be a catalyst for a moderation in allocations to private equity as investors are presented with genuine alternatives and opportunities in the fixed income space.
- **However, if there has been one constant in the evolution of private equity, it is the ability of the industry to learn from experience and adjust accordingly.** This time is unlikely to be different. Indeed, as we have seen, this may not be a bad thing from a societal perspective. There are numerous scenarios along which the buyout industry could evolve.[xxxvi] But if a leaner, more consolidated industry emerges on the other side, it may also be one that has acquired new skills and puts an even greater emphasis on making operational improvements to firms that make the overall economic pie larger and so help realise the promise inherent in private equity ownership.

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Endnotes

i Private equity includes not only buyout, venture capital, growth but also real estate and infrastructure. Note also that private credit has grown rapidly, reaching $1.4tn of AuM globally at the end of 2022, up from about $500mn in 2015, putting it on par with the US junk bond market. AuM includes dry powder and unrealised value and is for the period 2000-1H2021. Note this paper focuses on the buyout segment of private capital markets, which is often referred to as leveraged buyouts (LBO) due to the higher levels of debt used in transactions than public company benchmarks. Buyouts are structured as limited partnership and raised largely from institutional investors. In a buyout fund, the limited partners (LPs) make capital commitments – typically for ten years – that can be drawn down at the discretion of the fund managers or general partners (GPs). These draw-downs are used to acquire portfolio companies that are managed and ultimately sold by the fund. The GP controls the board, strategy, management and operations of the company, appointing the board of directors as well as senior operating managers. The GP earns management fees and is entitled to a performance-related share of realised profits 'carry', while LP returns come from the difference between the cost and the sale price, plus any dividends received. Buyouts are the largest segment of private markets in terms of assets under management (=31% of private market AuM in 2021), though it is worth noting that the line between buyouts and other private market asset classes such as growth equity has been blurring in recent years.

ii https://www.theguardian.com/business/2022/mar/17/empty-department-stores-slow-revival-covid-stricken-high-streets

iii Using the terminology of Liberti and Peterson (2018), intangibles involve 'soft' information – information that is fuzzy and qualitative, requires contextual knowledge to understand and frequently has uncertain and weak timing links to performance. Consistent with the high information complexity of intangible assets, Gu and Wang (2005) find that analysts' earnings forecast errors are larger for more intangible-intensive firms. Palmon and Yezegel (2012) present empirical evidence that analysts' recommendation revisions are more valuable for firms with high R&D intensity that is consistent with the hypothesis that R&D intensity increases information asymmetry. Dugar and Pozharny (2021) find that the value relevance of book equity and earnings has declined only in high intangibles firms, and not in low intangibles firms.

iv Some of this is due to composition effects and the trend towards buyouts in the technology sector. Technology companies have commanded higher multiples and valuations. Nonetheless, Bain (2021) finds that sector mix is an insufficient explanation for rising multiples insofar as they have occurred across all sectors.

v PME – or public market equivalent – attempts to make a direct comparison between returns for investors in private equity and public markets. Specifically, it takes into account the timing of capital calls and distributions, synthetically investing those cash flows into public markets. Through this method, one can compare the returns of private equity with the closest public market alternative into which shareholders could invest their capital. PME is generally presented as a ratio between private equity and public market returns. A ratio above 1.0 indicates relative outperformance and below 1.0 means underperformance.

vi A number of composite indicators have been developed to track how changes in longer-term interest rates, credit spreads, exchange rate and equity prices affect the real economy and assess how 'easy' or 'tight' financial conditions are.

vii Note the industry has been doing larger private-to-private consortium deals. Indeed 2021 witnessed the largest buyout involving a consortium of private equity firms since the financial crisis, the $34 billion acquisition of Medline by Blackstone, Carlyle and Hellman & Friedman.

viii Jon Moulton also points out that as funds get larger, so there will be fewer deals to chase: "Scale matters but they are beginning to run out of prey. Indeed it was one of the theories as to what happened to the dinosaurs. They ran out of prey and you know there's something like that going on now. We have reached the size limits of the industry pretty well and you also see the very large funds getting rather accident-prone. Less publicly, the SoftBank fund for example which it now transpires was happy to do very large investments with hardly any due diligence.

ix Anecdotally, there are signs that a partial rethink is already beginning to happen. For example, Calpers, the largest public pension fund in the US, recently announced that it will invest $500m each with TPG Inc. and GCM Grosvenor to help launch funds supporting up-and-coming private equity firms (Lim, 2023).

x For example, virtually every leveraged loan borrower has taken advantage of low rates in recent years to refinance such that the amount of leveraged loans maturing in 2023 has fallen by about three-quarters since the start of 2021 (Goldman Sachs, 2022).

xi In a sign of changing times, floating rates for loans on LBOs averaged 4.8% as late as February 2022 before doubling to 9.8% in September 2022. Interestingly, some PE firms are actually taking leverage out of leveraged buyouts, anxious not to be locked into increasingly expensive debt and maintain maximum flexibility until borrowing conditions improve. Examples include Francisco Partners, Thoma Bravo and Stonepeak Partners that have recently announced deals with 100% equity, using cash from their own funds (Scigliuzzo and Davis, 2022).

xii At the time of writing, it had already begun to ease, raising the question of how far, and how fast, it will come down.

xiii History suggests that once inflation goes above 5%, it takes, on average, a decade to drop back to 2%.

xiv These contrasting trends are attributed to the shift towards larger buyout deals with higher valuations and more focused on growth.

xv This is due to the fact that total leverage is expressed as a multiple of EBITDA.

xvi Historically, revaluations have tended to lag behind public markets by a minimum of six to nine months.

xvii It is a sentiment shared by prominent asset owners such as Harvard University's $51bn endowment that has warned of substantial markdowns to come in its private equity portfolio (Gara, 2022). For public pension funds, declining private equity asset values could lead to more unfunded liabilities (Randazzo and Moody, 2023).

xviii Depending on the structure of the fund, some PE funding will have been raised on a ‘when called’ basis – capital committed by the LP but not yet paid to the GP. Whatever legal protections are in place, the PE fund may discover this ‘dry powder’ is not as easy to call as trustingly supposed if LPs’ ability to pay is impaired by deteriorating market conditions. In this scenario, the GP may decide against sending a formal call notice rather than go through the bad optics and controversy of disagreement with investors. The risk of informal broken calls was flagged by the gilt crisis in the UK in late 2022 when pension funds were forced into fire sales of their liquid assets. At the time, it is not inconceivable that a GP wishing to make a capital call would have met some resistance. These risks are heightened by the increasing interconnectedness and opacity of capital markets, making it extremely challenging to build a full picture of who is exposed and on what scale (Deutsche Bank, 2022).

xix EQT’s purpose – to future-proof companies and make a positive impact – explains its emphasis on sector expertise, innovation and leveraging new technologies (Holmberg and Karlberg, 2018; Eccles et al., 2020).

Since its inception, it has been supported by the EQT Network – a body of more than 500 international, independent advisors consisting of former industrial leaders, successful entrepreneurs and former politicians who provide a vital source of competence to the portfolio companies. It has rolled out digital tools like Motherbrain, EQT’s proprietary AI, that uses machine learning and artificial intelligence to identify promising start-ups, including those with racially diverse founders (Cao et al., 2021; Levingston, 2021).

For EQT, sustainability goes beyond ESG frameworks aimed at risk mitigation and compliance. It is a holistic strategy integrated across the investment process and portfolio and seeks to drive sustainable value creation within portfolio companies.

Once an investment is made, EQT seeks to ensure that portfolio companies are meeting the ownership expectations set out in its EQT Sustainability Blueprint through a robust accountability and performance framework.

This is made up of three groups of objectives: EQT Absolutes, EQT Core key performance indicators (KPIs) and portfolio company-specific KPIs that translate key strategic sustainability topics into KPIs to monitor and improve upon. Progress is reviewed by EQT on an annual basis to ensure progress against short and long-term targets. Where possible, KPIs are benchmarked against peers, other EQT portfolio companies and comparable public companies.

There have also been efforts to translate KPIs into financial metrics, drawing on nascent initiatives such as Impact-Weighted Accounts. EQT has also established ESG-linked credit facilities at the fund level, creating an additional layer of accountability related to sustainability achievement. Throughout the investment process, EQT’s in-house team of sustainability professionals works closely with investment professionals both as a challenger and to support on the execution of both downside risk protection and sustainable value creation.

xx For a discussion of sustainability-linked bonds in PE, see https://cib.bnpparibas/propelling-sustainability-linked-bonds-into-the-private-equity-sector/ and https://www.nuveen.com/global/insights/fixed-income/sustainability-linked-bonds-do-not-fit-our-impact-framework.

xxi A decade ago, Blackstone was among the most active champions of the US shale boom; today, it has significantly pared its bets on the exploration and production of oil and gas and its next energy fund will avoid these upstream investments, instead focusing on the energy transition to net zero. Blackstone will remain in downstream activities – transporting, storing and processing gas and fuel – in part because infrastructure like pipelines can be repurposed for renewables as well as carbon dioxide from carbon-capture projects.

xxii One could argue that maximising the returns to people and talent investment and to a lesser extent tech investment/digital transformation presupposes activities consistent with ESG and purpose.

xxiii The proxies used by the authors to measure short-termism are relatively crude and may pick up other firm characteristics such as size and growth that are responsible for the decline in injury rates. Other studies find higher analyst coverage leads to improvements in workplace safety.

xxiv Ownership Works has emphasised that it will not let participating companies use stock grants as a substitute for wage increases and shares should be treated as a free benefit rather than having employees buy them.

xxv Returns are uncertain in the sense that the value of employee satisfaction is realised in some situations but not others reflecting nuances in execution and the enabling environment; and they are distant in the sense that benefits arise far into the future and are often tied more closely to the behaviours enabled rather than the investments that make those behaviours possible.

xxvi This corresponds to a mortality cost of about $21 billion in 2016 dollars which is about twice the total payments – $9 billion – made by Medicare to PE facilities over the period.

xxvii To support a causal conclusion, the authors use the differential distance from the patient's home to different providers as an instrument. Conceptually, this exploits the well-known preference of patients for a nursing facility close to their home. As this distance is unrelated to patient characteristics that might drive both their decision to use a PE owned nursing home and the quality of their care; it effectively mimics random assignment to isolate the impact of PE ownership. Broad geographic coverage, a long sample period, comprehensive patient level data and a large number of deals are distinctive strengths of the study. It is nonetheless worth noting that other studies reach slightly different conclusions. Notably, Huang and Bowblis (2019) find no immediate evidence of decline in quality metrics for long stay residents in PE owned nursing homes in Ohio relative to other for-profit institutions in the state. However, as the authors point out, the impacts of private equity ownership on long stay may not carry over to post-acute care patients where focus is on regaining function and returning home. Moreover, they only compare PE ownership with for-profit nursing homes that are arguably closer in behaviour to private equity owned facilities than non-profit and government facilities. This limited comparison set precludes a full assessment of the relationship between ownership status and quality of care, especially in light of evidence that non-profits often generate superior outcomes (Grabowski et al., 2013).

xxviii Specifically, a 10-percentage-point increase in a firm's investments in portfolio companies in countries with mandatory reporting is associated with a 2.3% increase in PE firms' environmental disclosures.

xxix A timely example is the utilities sector where elaborate efforts to mimic competitive markets by setting prices ex ante through RPI-X and periodic reviews have created a number of perverse incentives. For the experience of the water sector, see Helm (2020).

xxx Specifically the authors analyse local public finances in Germany and find that portfolio companies' effective tax rates and total tax expenses decrease by 15% and 12% after buyouts.

xxxi These include investments related to information technology comprising social networks, applications for consumers, and software and services for enhancing business productivity.

xxxii Fewer than 25% of GPs, for instance, have the ability to report on scope 1 or 2 carbon emissions all or most of the time.

xxxiii Gilson et al. (2010) show how formal arrangements can be 'braided' with informal mechanisms so as to facilitate learning and commitment in an ongoing relationship whose precise ends may be too poorly defined to structure into a meaningful contract.

xxxiv Page 165.

xxxv LP skills are also critical in the context of running direct investment and co-investment programmes that allow institutions to access to the private equity market without having to pay the substantial fees associated with investing through a fund (Braun et al., 2020).

xxxvi For example, David Rubenstein, Co-founder and Co-chairman, believes that fading recession risk should see private equity deal activity gather pace and that private marks are – if anything – more likely to rise than fall in 2023 and beyond (Goldman Sachs, 2023).

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