Private equity: retrospect and prospect

by **Mike Wright, Centre for Management Buyout Research, Imperial College Business School**

1999 was certainly a momentous year. The euro was introduced, with the Conservative Party in opposition outperforming the Labour Party in the European elections, a result claimed by its then-leader as a vindication of the party's opposition to the single European currency. In football, well-known leveraged buyout Manchester United secured a unique treble with last gasp goals against European opposition in the Champions' League.

As the second private equity wave got under way, the market in 1999 rose for the sixth year in a row following the recession of the early 1990s. This pattern continued for a further 12 months before the fallout from the bursting of the dot.com bubble put the market into reverse for a couple of years. The industry then recovered to reach record levels of value in successive years between 2005 and 2007, emerging from under the radar of public awareness and becoming subject to widespread and critical scrutiny.

Fast forward to 2017, and the European question now involves the uncertainties associated with Brexit. Manchester United again achieve a treble (if we include the Charity Shield) with a win over European opposition, this time in the Europa League. Political fortunes are somewhat reversed with a resurgent and avowedly Marxist Labour Party, perhaps giving the private equity industry reason to be concerned about what some might see as another type of Red Devil than the ones based at Old Trafford. Private equity fundraising continues at high levels and deal values are on the rise, driven by a relatively small number of larger transactions against a backdrop of a sharp decline in deal volume. Yet, the dominance that the UK had in the European market in 1999 is now challenged with deal value currently neck-and-neck with that in Germany.

The Centre for Management Buyout Research has pioneered monitoring of developments in the private equity market during this period, our interest stretching to the beginning of the first wave as far back as 1981 with the organisation of the first management buyout conference, and the centre's formal establishment in 1986. It seemed to me at the time that this was an important new development with the potential to contribute to economic renewal that we needed to know more about. My soon-to-be head of department didn't exactly agree, telling me, as a very junior academic at the time, that I was wasting my academic career on such a peripheral and esoteric topic that would disappear as soon as the recession was over.

In the period since 1999, a substantial body of rigorous systematic studies has now accumulated worldwide. This research enables us to dispel myths about the impact of private equity and buyouts that have arisen around the oftentimes anecdotal evidence of both critics and protagonists.

This work shows unambiguous improvements in profitability and productivity, with employment effects being more ambiguous and dependent on both the nature of the buyout transaction and the time period after the deal has been completed. Current work with my colleagues Nick Bacon and Kim Hoque shows that there is no consistent evidence of higher job insecurity in firms that have gone through a buyout compared to other firms in terms of workforce reduction practices (e.g. redundancies and redundancy consultation), dismissal rates and labour use practices (e.g. outsourcing and non-permanent employment contracts).

Buyouts are oftentimes accompanied by increased new product development and can ease financial constraints on innovative activity, including patenting.

We also have some evidence of an increase in exporting activity by firms following a buyout. Taking into account like-for-like leverage and other factors, private equity backed-buyouts are not significantly different in failure likelihood than non-buyouts. Private equity firms typically select companies for investment that are less financially distressed than other comparable companies, and so these firms should be in a stronger position to service the debt, while buyouts backed by more experienced private equity firms are less likely to fail. Private equity-backed buyouts are overwhelmingly not a short term ownership form, with average time to exit increasing over recent years and now around the six year mark.

Yet for the future, vexed questions remain: where are sufficient good deals to come from and how are returns going to be generated? Secondary buyouts extend the longevity of the buyout form to a new set of owners and managers and have grown massively in importance in recent years to a level comparable with primary deals as the latter have become harder to source. However, studies report mixed evidence on the performance of such deals, suggesting that the gains seen in primary buyouts are difficult to achieve the second time around, and that on average it's often more a question of growing the business through acquisitions than improving profitability and productivity.

If efficiency gains in the primary buyout have largely been exhausted, there may be a need for a greater advisory role of directors from private equity firms to identify and take advantage of entrepreneurial growth opportunities.

My recent deal-level work with Ranko Jelic and Dan Zhou shows that the governance benefits of the private equity buyout model tend not to be exhausted in the primary buyout stage but the effects depend on the nature of the skills that directors from private equity investors bring to the business. In particular, their financial (rather than operational) experience tends to have a substantial impact on post-secondary buyout profitability while high level business education (MBAs) is especially important in increasing revenue growth.

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