Private equity and value creation

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Private equity (PE) remains an underutilised source of funding for firms in the EBRD regions. This EBRD Impact Brief explores how private equity can help companies prosper. It reports on a detailed study of both textual and financial data from more than 170 private equity funds that the EBRD invested in over a period of 25 years.¹ The findings show that PE funds follow a rich set of strategies to create value during the life of a deal. These strategies typically increase operational efficiency in the companies they support – boosting investment, employment and sales – even when compared with equally high-growth and profitable companies. The data show that most operational improvements instigated by PE funds persist after the funds have fully exited their investments.

What is private equity?
Private equity financing fills the gap between internal financing and more conventional funding sources such as bank loans and public equity. It is risk capital provided to companies with high growth potential, start-ups, young firms at an early stage of development and, in some cases, firms that require financial restructuring.

A private equity fund is a collective investment scheme that attracts capital commitments from a variety of institutional investors and from the fund managers themselves. It usually operates as a limited partnership, and is controlled by a private equity firm, which typically makes investments in non-listed companies and provides portfolio companies with not just capital but also strategic and managerial support.

Each portfolio company is managed for around four to six years and an exit is achieved when the fund is able to realise its investment. This occurs when the company has grown sufficiently, or has become financially sound, and the fund sells the company to a strategic investor (usually a company in the same industry), financial institution, another PE fund, the company’s management team or owner, or floats it on the stock market through an initial public offering (IPO). Proceeds from these exits are then returned to the investors after management fees and other fees have been deducted.

How do PE funds create value?
Most of the private equity investment in the EBRD regions involves growth capital and early-stage financing. Growth capital targets relatively mature companies that are looking for equity capital to expand and improve operations. Early-stage financing targets young companies without profits but with high growth potential.

PE funds follow various value-creation strategies to improve the operations and profitability of their portfolio companies. To document these strategies, the research team read thousands of documents that PE funds typically provide for their investors, including investment committee memoranda, advisory board presentations and quarterly reports. These documents contain a wealth of information on funds’ proposed changes in portfolio companies to create value, which the researchers captured in 23 individual indicators. The indicators record whether or not the PE fund intended to: i) optimise capital structure and introduce financial incentives to senior management; ii) upgrade physical assets, reduce costs or improve information technology (IT) systems and logistics; iii) renegotiate terms with customers and suppliers; iv) pursue mergers and acquisitions, change product offering or pricing or invest in marketing; and v) replace the CEO or CFO of a portfolio company.

The study groups this information under five headings, which reflect the main value-creation strategies followed by PE funds. These are: financial engineering; operational engineering; cash management; top-line growth; and management and governance (see Chart 2).

In “operational engineering”, PE funds actively engage in upgrading and investing in physical assets, cutting costs and improving IT systems or distribution and logistics at portfolio companies. This is the most popular value-creation strategy pursued by PE funds in the EBRD regions, with around 80 per cent of all deals initiated over the past three decades having involved one or more of these plans. All types of deal analysed – from early-stage to buyout – engaged in operational improvements.
An equally popular value-creation strategy among PE funds is “top-line growth”, which aims to boost revenues. Many PE funds report pushing the mix of products and services offered by their portfolio companies towards higher-margin products, investing in marketing and sales teams, improving pricing and quality, and pursuing mergers and acquisitions. Alongside this, they develop international expansion strategies to target higher market shares and to become more profitable. This value-creation strategy is pursued especially in deals involving growth capital and buyouts.

In recent years, PE funds have also moved towards creating value through “financial engineering” and changes to “management and governance”. These two strategies often go hand in hand, typically in the case of buyouts, as PE funds’ use of debt in company acquisitions increases. This use of borrowing tends to increase financial discipline in portfolio companies whose managers’ performance is closely tracked by PE funds and often tied to companies’ top-line growth or profitability by incentive schemes.

Unlike stock market investors, private equity investors typically acquire significant equity stakes that include rights to nominate directors and appoint operating partners. As a result, investors adopt a more hands-on approach when managing their investments. In the deals analysed by the research team, PE funds were able to pursue all five value-creation strategies in more deals when they had greater ownership of their portfolio companies.

PE funds typically achieve their initial plans to create value

PE funds regularly report on the state of the portfolio companies to their investors, not only in terms of financial outcomes, but also regarding whether their intended plans to create value at the time of signing were successful or not. Based on such reporting, the study keeps track of achievement relative to the 23 indicators, or plans, for each deal. On average, PE funds set out to implement three to six of these plans and they go on to achieve the majority of them (see Chart 3). Some PE funds may set out to implement more plans, but the probability of achieving these drops with
the number of initial plans. The study suggests that while the number of value-creation plans does not predict returns generated for investors, the percentage of plans achieved correlates with investor returns.

**Chart 3. Value-creation plans and achievement**

PE leads to operational improvements and growth in employment and sales

To answer the question as to whether data on company-level financials support the findings from textual analysis on value-creation plans, the research team obtained detailed data on portfolio companies’ balance sheets and income statements as well as on their employment. PE funds invest in companies in the EBRD regions that experience high sales growth and that are already profitable, so it is important to identify similar companies – but ones without the backing of private equity – to demonstrate the impact of private equity funding. The researchers identified up to five firms from the same country and industry that are comparable in terms of size and revenue growth to each portfolio company to serve as a “control group”.

An econometric comparison of the portfolio companies and their controls supports the idea that PE funds create value by following the strategies listed above (see Chart 4). In particular, PE-backed firms see an increase in their use of debt and a reduction in their effective tax rate while they are under PE ownership. This suggests that the PE funds’ strategy of financial engineering can add to companies’ value, as interest payments on loans are tax deductible in many countries.

The analysis also shows that PE-backed companies see substantial improvements in their operations. Over the time that companies spend in a PE fund’s portfolio (an average of five years in the sample), their employment levels increase by an average of 26 per cent, the capital stock per employee by 28 per cent and labour productivity by 9 per cent. All of these increases exceed the corresponding changes at control companies. PE-backed companies also develop improved methods of cash management, as their working capital (as a share of total assets) is reduced by 4.6 percentage points while under PE ownership.

At the same time, the analysis provides evidence of a significant impact on top-line growth, profitability and potentially positive outcomes for consumers. During the time that companies spend in a PE fund’s portfolio, their operating revenues increase by an average of 39 per cent and their profitability (as measured by earnings before interest, tax, depreciation and amortisation (EBITDA)) by an average of 25 per cent. The study also finds that mark-ups (which capture the price charged by companies as a ratio to their costs of production) charged by portfolio companies fall by an average of 5 per cent. This suggests that cost reductions achieved through operational improvements are passed on to consumers through lower prices.

**Except for financial engineering, improvements persist after exit**

The study also explores whether the effects that companies experience under PE ownership persist beyond exit. In other words, whether value creation instigated by PE funds is reflected in economic outcomes even after funds have fully exited their investments.

The analysis finds that, except in the case of “financial engineering”, the effects of value-creation strategies survive beyond the presence of PE funds in portfolio companies. Notably, these companies continue to enjoy high revenue growth, higher levels of labour productivity and total factor productivity and lower working capital needs in the long term. They also continue to pass on the cost reductions to their customers. This suggests that lower prices reflect genuine efficiency gains and not simply strategic pricing to gain market share.

**Operational value creation drives returns for investors**

The last issue that the study analyses is whether financial returns that PE funds generate for their investors are driven by their value-creation strategies. The study shows that PE investments in the EBRD regions have delivered returns in excess of public equity (or market) benchmarks. This suggests that these funds succeed in translating their value-creation strategies into financial returns for investors. However, critics of the private equity industry point out that PE funds may simply time their investments well (for instance, taking advantage of low borrowing costs to increase leverage), while contributing little to the operations of investments to generate returns.
The study finds that, even after considering such timing effects, improvements in operational efficiency and revenue growth are strongly associated with higher investor returns. Firms in the EBRD regions that experienced higher sales growth and productivity when they were part of a PE fund’s portfolio also generated the largest returns for investors.

Lessons learned
Investors commit capital to private equity funds in search of financial returns. Private equity funds promise to deliver returns for their investors by following various value-creation strategies. Whether they actually create value – and if so, how exactly they do it – has been elusive so far.

This Impact Brief uses results from an in-depth analysis of these funds’ value-creation strategies based on thousands of documents as well as data on economic outcomes at the level of the companies that these funds supported. The analysis documents that PE funds follow a number of value-creation strategies, and typically manage to implement these strategies and generate financial returns for their investors by increasing operational efficiency and revenue growth within the companies they support.

Three key implications emerge from this analysis. First, private equity funding in the EBRD regions remains underutilised (see Chart 1). PE funds can contribute to more diverse financial infrastructure and provide companies with both long-term risk capital and industry expertise. The analysis shows that the funds may be able to create financial and economic value by improving the operations, governance and debt capacity of the firms they invest in.

Second, value is created when industry expertise, managerial skill and access to additional financing are combined within a framework that is intended to generate positive economic outcomes. Hence, providing risk capital without clear business planning and leadership is often insufficient.

Third, in the EBRD regions, the main driver of returns in private equity investment continues to be revenue growth and improvements in operational efficiency. This suggests that firms are at a greater advantage when they are funded by providers of risk capital who are better at identifying high-growth firms and who are more “hands-on” during the time that they manage these firms.
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Suggestions for further reading
