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In This Issue: **Private Equity**

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Morgan Stanley Roundtable on Private Equity and Its Import for Public Companies

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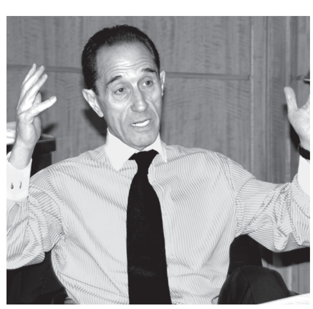

Alan Jones: Good morning, I'm Alan Jones, Head of Corporate Finance here at Morgan Stanley, and I want to welcome you all to this roundtable discussion of private equity. I think the highest compliment you can pay someone is to say that you have learned from him or her. I have learned from a number of people at this table, and I expect to learn a great deal more today. I'm especially pleased to have the chance to discuss this subject with Michael Jensen, who was my professor at the Harvard Business School over 20 years ago—and who, as I've just discovered in the past few minutes, has taught most of the people in this room. So thanks for joining us, Mike, and we hope you will go on teaching us for a long time.

The people at this table represent an impressive assembly of both academic and practitioner approaches to private equity. So let me begin just by introducing everyone. And I'm going to start with the academics since I've gone to the trouble of writing down the names of the chaired professorships and committing them to memory.

Michael Jensen is the Jesse Isador Strauss Professor of Business Administration Emeritus at the Harvard Business School. While at the University of Rochester in the '70s, Mike wrote a paper with Bill Meckling on "Agency Costs and Theory of the Firm" that revolutionized the theory of corporate finance by focusing on the conflict of interests and incentives between management and shareholders that reduces the value of public companies. And after he moved from Rochester to Harvard in the '80s, Mike became the most prominent and vocal academic spokesman for leveraged buyouts, or what is now known as private equity, as a way of overcoming this agency problem in public companies. But, for all of his academic accomplishments, most of Mike's time these days is spent outside the academy. Since 2000, he has been Managing Director of the Monitor Group's Organizational Strategy Practice. And he is also the Co-Founder and Chairman of Social Science Electronic Publishing, or what most of us know as "SSRN."

Steven Kaplan is the Neubauer Family Professor of Entrepreneurship and Finance, as well as Faculty Director of the Polsky Entrepreneurship Center, at the University of Chicago's Graduate School of Business. To go along with his many published papers on private equity and entrepreneurial finance, and on corporate governance and M&A, Steve has been recognized as one of the top-rated business school teachers in the country. He also serves on the boards of three companies: Accretive Health, Columbia Acorn Funds, and Morningstar.

Meyer Feldberg is, happily for us, a Senior Adviser at Morgan Stanley. Meyer has been associated with more academic institutions than time permits me to name. He was the Dean of Columbia's Business School from 1989 to 2004; and before that, he served as President of the Illinois Institute of Technology, Dean of Tulane's Business School, and Associate Dean of Northwestern's Kellogg School. Perhaps most relevant for this discussion, Meyer has served on the boards of a number of public as well as private companies, including Revlon, Federated Department Stores, PRIMEDIA, Sappi Limited, UBS Funds, and Select Medical Corporation.

Now let's turn to the people in our group who *practice* private equity:

Carl Ferenbach is a Managing Director at Berkshire Partners, a private equity firm that he co-founded in 1986. Prior to helping start Berkshire, Carl was a partner at the Thomas H. Lee Company and, before that, a Managing Director of Merrill Lynch in charge of the firm's M&A and leveraged buyout practices. Carl has been chairman or a director of many of Berkshire's companies, including Crown Castle International, U.S. Can, and Wisconsin Central—the last of which provided the material for one of Mike Jensen's case studies that continues to be used at Harvard. As you can guess from this list of companies, Berkshire's investment strategy has included the transportation, communications, and industrial manufacturing sectors.

Brian Hoesterey is a Partner of AEA Investors, a buyout firm started in 1969 that has a reputation for bringing extensive operating experience to its deals. Brian joined AEA in 1999 and focuses on investments in the specialty chemicals and value-added industrial products sectors. He currently serves on the board of directors of Compression Polymers, Henry, Pregis, and Unifrax. Before joining AEA, Brian worked for BT Capital Partners, the private equity group of Bankers Trust, McKinsey & Company, and Morgan Stanley. Like a number of other people here, Brian received an M.B.A. from Harvard.

John Moon is a Founding Partner and Managing Director of Metalmark Capital, a private equity firm that is active in a broad range of industries, including industrials, healthcare, financial services, and energy and other natural resources. John is a director of a number of Metalmark portfolio companies. Prior to helping start Metalmark in 2004, John was a Managing Director of Morgan Stanley Capital Partners and, before that, he was a Vice President in the Investment Banking Division of Goldman Sachs. John has a Ph.D. as well as an A.M. from Harvard, and he is an Adjunct Professor of Finance at Columbia Business School.

Cary Davis is a Managing Director at Warburg Pincus, where he focuses on investments in software and financial technology companies. With investments closer to the growth end of the spectrum, Cary operates more like a venture capitalist than a leveraged buyout specialist. He is a director of Cassatt, GlobalSpec, Pi Corporation, TradeCard, Secure Computing, and Wall Street Systems. Like John, Cary is also an Adjunct Professor at Columbia.

Now that I've mentioned our cast of characters, let me set the stage by telling you a bit more about what we plan to discuss. There are two main questions that I'd like us to consider. The first is: How does private equity add value? Or, to make it a bit provocative, *does* private equity add value? And in this first part of the discussion, I'd like us to explore how the answers to those questions have changed over time. I for one think that the role of private equity in the industrial restructuring of the U.S. in the 1980s is very different from the role it is playing today, particularly in the U.S. And, as we look at other parts of the world, including Europe and Asia, I would also like us to consider the possibility that private equity will play the transformative role in those places that it did here in the '80s and '90s.

The second main question I'd like us to think about is this: What are the implications of private equity for public companies? And here let me set the table a little bit. None of us needs to be reminded of the increasing importance of private equity. There's clearly an enormous amount of money dedicated to it right now. Morgan Stanley estimates that there are now some 2,700 funds that either have raised, or are in the process of raising, a total of half a trillion dollars. When you add the leverage that can be put on top of these funds, this is an enormous amount of purchasing power. When a number of us here were at the Harvard Business School some 20 years ago, there were probably only four private equity firms that had $1 billion funds. Today there are more than 150 firms of that size. In fact, the largest new funds being raised these days are in the $10-$14 billion range. And by virtue of their increasing size, and their willingness to work together in "club" deals, they can do much bigger transactions than was ever thought possible. With all this equity capital available, and with the help of remarkably forgiving leveraged finance markets, today's financial sponsors are able to pay much higher prices for assets than they could five or six years ago.

So, we're clearly seeing private equity firms paying bigger prices, doing larger deals, and, as a result, having a much more significant role in the global economy than they did ten or 20 years ago. Private equity transactions now account for a quarter of all global M&A activity—and they also account for half of the leverage loan volume, a third of the high yield market, and a third of the IPO market.

So none of us around this table needs to be reminded of the importance of private equity. And, as I said earlier, I want to use this forum to explore the implications of the enormous growth in private equity for public companies. It raises questions that managements and boards may soon find themselves addressing if they have not already: Is our company leaving value "on the table" in the form of excess cash and unused debt capacity? Is it possible that we would operate more efficiently, and be more valuable, in the hands of a private equity firm? And if we decide that we're more valuable as a public company, should we consider taking a page out of the private equity playbook and invite some of our largest investors onto our board?

I'm going to start by asking my former professor—and I can't tell you what a thrill it is for me to be "cold-calling" Michael Jensen like this—the first of our two main questions: How do private equity firms add value? And, again, just to be provocative, *do* they add value?

Part I: How Private Equity Adds Value

Jensen: Thanks, A.J., for all the kind words.

In answer to your first question, I have no doubt that private equity adds value—and it has been adding value since the movement took off in the early '80s. Some of the players have changed, and the financing structures and the kinds of companies taken private have changed somewhat. But the general results, as can be seen in the operating gains and rates of return that have been documented by all kinds of academic studies, have been very impressive. Now, as happens with all economic activities, there have been failures as well as successes. There have been periods of overshooting, with too many players chasing too few good deals. At the end of the '80s, for example, there were a lot of overpriced deals because the buyout firms, as I argued in the early '90s, were not putting enough of their own capital into the deals. But, on the whole, the market has spoken in the summary of the growth of private equity activity that you just gave. Private equity has clearly succeeded in adding value; if it hadn't, the funds wouldn't be able to raise so much capital today.

Back in the mid-1980s, when I first became interested in what is now called private equity, one of the events that affected me a lot was meeting Carl Ferenbach at a session somewhat like this one. Carl had just come back from a week of riding around on a "Hirail" car in northern Wisconsin. He was focused on Berkshire Partners' purchase of 2,000 miles of railway that was the core asset of Wisconsin Central. As a director of the company, Carl had become concerned about its performance and insisted on going out and meeting its customers and employees in person. And I thought to myself, "Well, this is really interesting. I don't know many directors of companies who spend their time riding around in railroad cars talking to employees and customers, especially in northern Wisconsin in January." Having grown up in Minneapolis, I know something about what that means.

So that was my introduction to private equity. And I learned a lot from Carl about what makes it work. In fact, we ended up writing a number of Harvard cases about some of Berkshire Partners' portfolio firms, including one on Wisconsin Central. And after watching Carl and his partners at work, and looking at the successes of some of the other firms like KKR and Clayton & Dubilier, it started to become clear to me that leveraged buyouts and what later became known as "private equity" were fundamentally a new way to think about corporate governance, a new model of management if you will.

I should also mention that around the time I met Carl, Steve Kaplan, who was then my Ph.D. student at Harvard, was finishing up his path-breaking doctoral thesis on management buyouts. And Steve's research, along with the important work of my colleague Bill Sahlman on venture capital, really focused my attention on this new management and governance model.

But then, as often happens with financial innovations, LBOs started to come under attack in the press and conventional business circles. Some of the worst deals that were getting done at the end of the '80s began to come apart. And the leveraged buyout of RJR Nabisco in 1989 for $25 billion, which became the subject of *Barbarians at the Gate*, was unpopular in large part because it was now seen as a threat to large public companies, to corporate America and the Business Roundtable. The fact that a firm the size of KKR, with 30 or 40 professionals, was willing to bid $25 billion—and was able to raise that much money—for the purchase of a company like RJR Nabisco was a revelation to me. After all, that $25 billion represented an almost 100% premium over RJR's value under its CEO Ross Johnson, which was about $13 billion before the firm was put in play. What I learned from reading *Barbarians at the Gate*—and I'm not sure the author ever realized what he had found—is that the sheer waste of value under Johnson, and thus the gain from taking the company private, was enormous; it was well in excess of $10 billion, even if KKR's investors never made a dime on the deal.

But just to lay some groundwork for the rest of this discussion, let me quickly summarize the arguments I was making back then. The growth of leveraged buyouts and private equity in the 1980s was part of a phenomenon that I characterized as "the rebirth of active investors." Active investors were people like J.P. Morgan in the 1920s who held large positions in both the debt and the equity of an organization, often served on the board, and were actively involved in the strategic direction of the firm. A series of laws and regulations dating back to the Depression, including the 1934 SEC Act and the Investment Company Act of 1940, had the effect of driving active investors off of corporate boards and pretty much out of the corporate governance arena. And the consequence of these laws and regulations, as I argued in a number of papers and forums, was a corporate America that was largely unmonitored and uncontrolled by outside investors. The result was massive inefficiencies—inefficiencies that were both reflected in and made worse by the conglomerate movement of the late '60s and '70s. These inefficiencies in turn provided opportunities for the so-called "raiders" and restructurings of the '80s, of which LBOs and private equity were an important part.

This may be hard for us to imagine today, but at the start of the 1980s, the shareholders of U.S. public companies were basically the only important stakeholder group that were *not* well represented in the corporate boardroom. And the inefficiencies that resulted from the absence of monitoring led, as I said,

After looking at the successes of firms like KKR and Clayton & Dubilier, it started to become clear to me that leveraged buyouts, and what later became known as "private equity," were fundamentally a new way to think about corporate governance, a new model of management, if you will. But what surprises me is that so few public companies are actually taking advantage of this new management model. I think it's possible for public companies to take almost all of the major competitive advantages of the private equity sector and implement them in one way or another without actually going private.

Michael Jensen

to the rise of corporate raiders and to the formation of these new organizations like KKR, Forstmann Little, and Berkshire Partners. When I started writing about them in the mid-'80s, I referred to them as "LBO associations" or "LBO partnerships." But after LBOs got a bad name, the term "private equity" came into vogue. And in the interest of clarity, let me mention that "private equity" comprises not only LBO firms like KKR, but classic venture capital firms like Kleiner Perkins—and, although there are important differences between these activities, there are remarkable similarities between the ownership and governance systems of venture capital and LBO firms, which is why we lump them together.

But whatever you want to call them, these new organizations found a way to accomplish much of what had been done by J.P. Morgan and other pre-Depression financiers. If you look just at their portfolios of assets, the LBO partnerships of the '80s were remarkably similar to the U.S. conglomerates, with lots of different businesses having no apparent synergies. But the LBO firms were set up very differently from their public company counterparts. They raised money to fund their activities not from public equity markets but from institutional investments in private limited partnerships in which the buyout sponsors were the general partners. Each unit or division of the LBO association was funded by debt and equity at the individual business unit or divisional level, not at the corporate level as in the conglomerates. And if you think about how conglomerates operate, this difference in financial structure can make a huge difference. Every business effectively stands on its own bottom, which means that financial problems that affect one operation cannot bring down another. And it is impossible for the LBO partnership headquarters to use funds from one business or division to subsidize the activities of others.

Equally important, the operating heads of each business have significant equity stakes *in their own businesses*—as opposed to, say, stock options in a diversified collection of businesses over which they exercise almost no control. And the equity stakes of these operating heads were considerably larger than those of U.S. public company CEOs. In a study of executive pay in U.S. public companies in the '70s and '80s, Kevin Murphy and I estimated that the average U.S. CEO in the '80s saw his personal wealth go up by about $3 for every $1,000 increase in the value of the firm. By comparison, Steve Kaplan's thesis found that the CEOs of businesses owned by LBO firms—the people who were previously running divisions inside conglomerates—earned about $64 for every $1,000 in shareholder wealth. So that's quite a change in incentives.

And just as important, under the LBO or private equity governance system, the performance of the operating companies and their top managements is overseen by much smaller boards that consist mainly of the firm's largest investors—other than the CEO, there are typically no insiders. And, as you can imagine, the kinds of discussions that take place in a room with just the firm's major owners are dramatically different from what goes on in most public company board meetings. The quality of these discussions is just much higher than what takes place with most public company boards. In fact, my sense is that the due diligence process that the buyout firms go through in vetting and pricing a deal causes those principals and their managers to learn more about the business than probably has ever been known since it was a public company, or a division of a public company. And the close contact between the buyout principals and the managers of the firm helps ensure that this detailed specific knowledge about the business—its customers, competition, employees, and so forth—stays up to date.

While I was working up one of my case studies with Carl, I was given the chance to observe a few of his portfolio company board meetings. The only formal board members were the CEO of the company and Carl and his partners. Other managers were in the room and played important roles, but they were there *ex officio*, not as board members. And I was struck by two things. One was that, unlike the public company board meetings I'd been in, there was a tremendous amount of conflict, disagreement, heated discussion. Also quite different from the practice of public company boards, the conflicts and issues that came up were never resolved by voting. There was lots of disagreement—arguments about things like whether the company should continue to run fast ferries between New Zealand's north island and the south island—but there were no votes. My rule of thumb is that if you end up taking a vote to resolve business questions like that—in fact for anything other than a legal matter—you're in real trouble; you've got a breakdown in the system.

So, I saw a board working in a way that was very different from what I'd seen in the public sphere. They were going at it hammer and claw and there were no punches pulled. But they generally reached agreement, and everybody seemed to like each other, when the day was done.

Another important difference between public conglomerates and private equity firms is that the funds have limited time horizons. Each fund has a finite life, typically seven to ten years. And the principals in the private equity firm have their reputations on the line. Because the limited partners have to be paid back in seven to ten years, those principals who want to stay in business have got to maintain a reputation that will allow them to get back into the market and raise new funds. These reputational effects are a very important feature of private equity; they provide discipline and pressure for increases in efficiency, but in a way that does not discourage companies from investing in long-term value. They are not driven by quarter-to-quarter market reactions to operating results.

To sum up, then, the structure and conventions of private equity have provided U.S. capital markets with a way to recreate old-fashioned active investing in a way that complies with the laws of insider trading and a bunch of other regulatory constraints. In the process, the private equity firms have invented—or perhaps "rediscovered" is a better word—a better way to run a group of different businesses, one that is very different from how the typical U.S. public company is run. The differences are so striking that I like to define private equity firms as "organizations that run governance systems that run businesses."

The result has been enormous increases in corporate efficiency and value. Looking back, we can now see that LBOs played a major role in restoring the profitability and competitiveness of American business in the 1980s. The new management model looked so promising to me that in 1989 I wrote an article in the *Harvard Business Review* predicting that LBO firms would end up taking over a large fraction of the mature sectors of the U.S. economy. I also predicted that the Japanese model of corporate governance, then viewed as the dominant model of business in the world, was failing and on the verge of collapse. I pointed out that the Japanese keiretsu looked very much like the U.S. conglomerates of the 1960s and early 1970s, and my prediction was that they would come apart at the seams and there would be a long period of decline.

All that has pretty much come to pass. It was essentially the leveraged restructuring movement of the 1980s, and the pressure for value maximization that came with it, that launched the remarkable increase in the productivity of U.S. industry in the '80s that has continued pretty much to this day. The private equity organizations were a major part of that effort to dismantle inefficient conglomerates and boost productivity. And I'm not at all surprised to see private equity spreading around the world. The only puzzle to me is why it has taken so long for this to happen.

Jones: Mike, your description of private equity has a lot to do with solving the agency problem of aligning the interests of managers and shareholders in public companies that you and Bill Meckling identified in the 1970s. Do you still see the growth in private equity as driven mainly by what you described as a governance issue, by the need to monitor and control corporate managers who are failing to maximize value?

Jensen: The main impetus for private equity has been the failure of public companies to maximize value. In the '70s and early '80s, the absence of effective monitoring of companies by investors led to all kinds of unproductive practices, some of which are still very much in evidence today. A major source of lost value in those days had to do with what I call the "agency costs of free cash flow." Much like today, in the 1980s the U.S. economy was full of companies with stable cash flow, large cash balances or unused borrowing power, and few valuable investment opportunities in their core businesses—investments that promised to provide returns above the cost of capital. In other words, companies had lots of "free cash flow," which I defined as cash that could not be profitably reinvested in the business. At the same time, top managers had strong incentives to keep that cash—and perhaps spend it on low-return projects, including diversifying acquisitions—incentives that have mostly to do with the personal benefits of running bigger organizations.

In this sense, the free cash flow problem is about the natural propensity of corporate managers—natural, that is, in the absence of significant equity ownership—to prefer size over profitability. By retaining rather than paying out excess capital, management keeps the reinvestment decision inside the firm instead of giving it back to the capital markets. And as I predicted then—and I haven't seen anything that would cause me to revise that prediction—the retention of excess capital leads to waste and value destruction. Some of that is still going on today. I would argue that Microsoft, for example, could significantly increase its own value by paying out a lot more of its excess capital than the $30 billion it announced a year or so ago.

The Performance of Buyout Funds

Jones: Thanks, Mike. Now that we've heard from Harvard, let's bring a representative from the University of Chicago into the fray.

Steve, you have done a great deal of research on the performance of the buyout funds. Following up on what Mike has said, I'd like to have a better understanding of whether and how private equity firms are actually making operating differences, improvements in how the businesses are run. Mike just suggested that the increased due diligence and monitoring, the attention to detail exemplified by Carl Ferenbach's long train trips to the hinterland, are a key source of value in private equity. Your work has tried to tease apart some of the strands—to identify the different major factors—that are thought to contribute to the overall performance and value of private equity. For example, there's a school of thought that says that the returns to leveraged buyouts and private equity are primarily the result of a highly leveraged bet on equities, with most of the benefits coming from the use of other people's money. You've done a lot of work to get at the root of how the best firms produce their returns. And, unless I'm mistaken, one of your most recent studies shows that while the industry as a whole has not outperformed the broad equity indices, the top firms consistently outperform those averages. Is that a fair statement of your findings?

Steve Kaplan: Thanks, Alan. I've been teaching a course on private equity for the last ten years, and researching private equity and corporate governance since I was one of Mike's doctoral students at Harvard back in the '80s. In my research, I have tried to answer the questions you just asked by studying private equity

In the late 1980s and after, more and more transactions saw buyout firms bidding against each other to do the financial and governance engineering. As a result, more of the value started to go to the sellers. Buyout firms have responded by developing industry and operating expertise that they can use to add value to their investments. This increased focus on improving operations is a big change. Given the combination of financial and governance engineering with this operational engineering, private equity is likely adding more overall value today than it did in the ’80s and the ’90s.

Steven Kaplan

investors both at the fund level and at the portfolio company level.

Let’s start with the company level, with the work that looks at the performance of the individual companies that are purchased by the private equity funds. In the thesis I did at Harvard under Mike’s direction, I gathered as much data as I could about these companies—data that were then and still are hard to come by. What I found—and this generally has been confirmed in later work by others studying both U.S. and European markets—is that companies that undergo LBOs and MBOs experience significant improvements in operating margins and cash flows. The operating improvements in my sample companies translated into above-market increases in both enterprise values—that is, the values of the companies’ debt plus equity—and in equity returns.

The next question this raises is, where do the operating improvements and the value-added come from? I think there are two main parts to the story. One has to do with what is referred to in the business as “financial engineering.” Mike doesn’t like that term because it has a negative connotation. It conjures up a picture of “financial” investors scavenging for undervalued assets, financing the purchase with debt, producing some “short-term” profits by cutting expenses, and then flipping the assets through a sale or IPO. LBOs do, of course, rely on debt financing—for tax and other reasons. But there is a lot more going on inside LBOs than financial engineering. And that’s why I think a better description of the process of adding value in LBOs is “financial *and governance* engineering.”

What do I mean by financial and governance engineering? Primarily three things. First is the change in management incentives. The early buyout firms discovered the importance of giving management a big equity upside in the company, and that was very unusual in the early '80s. They also asked—and still ask—management to make a meaningful and often substantial investment in the company. This way, management has not only a significant upside, but a significant downside as well. Another important feature of incentive compensation in LBOs is that management's equity is illiquid until the value is proved. So, you put your money in and you get a big equity stake, but you don't get to take it out—that is, you cannot sell a share of stock or exercise an option—until you've either created value or you have failed.

On top of the management incentives, you have the pressure of leverage, the need to produce enough operating cash flow to make payments of interest and principal. And that means that you don't have the free-cash-flow problem that Mike just mentioned where excess capital is sloshing around waiting to be spent. You have to pay out the money, which focuses the mind.

The third important piece is the active oversight by a board that consists mainly of the firm's largest investors. So, you have people like Carl, Cary, Brian, and John sitting on the board and making sure that management is doing what they've committed to do.

So, that is financial and governance engineering—and that's the essence of the story of how LBOs and private equity created value in the '80s. Today, there is another piece that was less prevalent in the '80s but has become increasingly important. You might call this piece "operational engineering."

In the late 1980s and after, more and more transactions saw buyout firms bidding against each other to do the financial and governance engineering. As a result, more of the value started to go to the sellers. Buyout firms have responded by developing industry and operating expertise that they can use to add value to their investments. They differentiate themselves by having the industry knowledge to ensure that their portfolio companies have effective strategies and operations, and by having a network of operating executives to ensure that their portfolio firms have the best managers and advice.

For example, Brian Hoesterey's firm, AEA Investors, was among the first to hire former CEOs to help manage their funds' investments. Berkshire Partners, Carl Ferenbach's firm, has had a strong operating focus since its start in the mid-'80s. In contrast to the pioneers in the '80s, almost every buyout fund today will say, "We have a strong operational focus. We have former CEOs, and we have former operating executives, who are going to help our companies add value."

The increased focus on improving operations is a big change. It is much more pervasive than it was 20 or even ten years ago. Given the combination of financial and governance engineering with this operational engineering, private equity is likely adding more overall value today than it did in the '80s and the '90s.

Now that I have talked about how private equity firms create value, the next question is whether that value creation is translated into returns to investors in the private equity funds. Antoinette Schoar of MIT and I studied that in a paper published last year in the *Journal of Finance*. We found that the average return on *all* the private equity or buyout funds in our sample—those raised from 1980 to 1995—was about equal to the return investors would have earned on the S&P 500 over that period. On average, then, we did not find the superior performance that is often given as the justification for investing in private equity. The result also appears at odds with the value creation story at the firm level that I just described.

But there are at least two reasons the average fund returns do not provide the whole story about the effectiveness of private equity investors. First, the returns are net of fees. Given the lucrative fee structure in private equity, it is safe to conclude that the private equity funds do beat the S&P *gross of fees*. Although the fees are difficult to estimate precisely, they effectively exceed 3% per year.

Second, the returns to the private equity funds do not take account of any gains to the sellers in the private equity investments. Because many of the companies are purchased in competitive auctions, it is common for a substantial amount of value added to go to the sellers. To illustrate this, consider KKR's purchase of RJR Nabisco that Mike mentioned earlier. KKR ended up paying $30 billion for the debt and equity of a company whose enterprise value was about $17 billion as a public company under Ross Johnson. And because they paid such a high price, KKR and its investors ended up earning a low return. In that deal, KKR effectively paid out the entire value added to RJR's public shareholders—something on the order of $13 billion. Although there was little left over for KKR's investors, a large amount of value was created.

Viewed in the light of fees and gains to sellers, our finding of average net returns is consistent with the idea that private equity funds add value. Now let's move to the second major finding of our study, which has to do with the best performers.

When you sort all the private equity partnerships into good and bad partnerships, there is a clear tendency for the better performers to repeat their performance and to outperform the market on a consistent basis and net of fees. That finding is important for two reasons. First, you do not see that kind of persistence in studies of other kinds of funds. For example, in studies of mutual funds, there is very little if any persistence, particularly on the positive end of the distribution. Today's best performers are not any more likely to be tomorrow's best performers than the typical fund today. And the same seems to be true of hedge funds: there is not much evidence of persistence in the data on hedge funds. But it is clearly there in the data on private equity, both for buyout funds and for venture capital funds.

And the finding is even more compelling in the sense that the differences between the best and worst performers are probably understated by a "survivorship" problem. That is, if your fund's performance is poor, you are less likely to raise another fund; and in this way, the worst-performing funds are continually culled from the system. This means that the funds that do make it into our tests are owned by partnerships that have succeeded in raising another fund. *Even within this group of surviving funds*, we find a statistically significant separation between the better funds and the worse ones.

A Practitioner's View

Jones: Thanks, Steve. Let's step out of the academy for a moment and turn to a seasoned practitioner of the art, Carl Ferenbach. Carl, how do you think private equity adds value? Both Mike and Steve focused on three benefits of private equity: direct monitoring of top management by the firm's largest investors; the pressure of heavy debt in forcing out free cash flow; and the alignment of incentives from giving the management team a meaningful economic participation in the success of their own business.

Based on your 20-plus years of experience in this business, what can you tell us about these and other ways in which private equity adds value? And please don't say that you too were a student of Mike Jensen's.

Carl Ferenbach: No, I'm too old for that.

Jensen: Carl *taught* my class.

Ferenbach: That's right. When Michael left the University of Rochester and came to Harvard in 1984, he started teaching a course called "CCMO," which is short for "Coordination, Control, and the Management of Organizations." And while Mike was certainly well known in academic finance circles at the time, he was new to Harvard and his views were pretty controversial. But within two years or three years of joining the faculty, much of that had changed. I remember Mike calling me and asking, "Can you come out and talk to my class? We're going to do the Wisconsin Central Case." And when I asked him how long this would take, Mike told me, "Well, I've got seven sections this year." What that meant was that virtually the entire second-year MBA class at Harvard Business School had signed up for Mike's course. The market had spoken. The course was asking some very important questions about the goals and governance of large organizations—and the students who were going back into the business world were apparently very interested in those questions.

One of the main drivers behind the growth of the LBO market was the institutionalization of capital that started around 1980. At that time, the pool of capital available for such transactions resided mainly in insurance companies. But it then began to spread to university and private endowments, and to retirement funds, including the pension plans of large corporations and state governments. The states of Michigan, Wisconsin, Washington, Oregon, and California were all early participants in funding the financial entrepreneurs who created the leveraged buyout business.

The people who went into the LBO business back then, including my partners and me, did so because we thought that owning and helping to run businesses would be interesting and fun—and maybe even profitable. And the kinds of businesses that we were looking at came from two main sources: the public conglomerates that Mike mentioned earlier and private, founder-owned businesses without a clear succession plan.

Although conglomeration may have been a value-maximizing strategy for companies in the late '60s and '70s, by the early '80s conglomerates were clearly proving to be an inefficient way to organize companies and deploy capital. What conglomeration meant in practice was that there were a lot of people inside large organizations running businesses while having zero ownership of those

We run our board meetings with our portfolio companies in two buckets. We don't talk about financial information until after we've had an afternoon talking about how the business is working. The financial information is just supposed to provide a check on the business. And if the information doesn't mirror the business reality, we all know that it isn't right; it isn't measuring what's going on in the business. But you won't know that unless you spend time asking all those other questions first.

Carl Ferenbach

businesses. And they had very little to say about what happened to the profits generated by their businesses, which typically went somewhere else in the organization. Conglomerates were notorious for misallocating resources and, by the early '80s, it was clear they were failing to produce acceptable shareholder returns. And one of the functions of the early LBOs was to help pull the conglomerates apart. But I should add that we did only friendly deals; we were buying only when they were selling.

At the same time, there were a lot of World War II veterans who had founded businesses after the war and had reached the point where they needed to make changes in the ownership of those businesses for estate reasons. Leveraged acquisitions were a way for the companies to remain independent and, in many cases, for a new generation of managers to become owners with us.

So, the original leveraged buyout business was a combination of divestitures by conglomerates and private sales. It was a business where the equity put up 10% to 15% of the capital and lenders put up the rest. The prices were much lower than they are today, in part because there wasn't much of a credit market. Mike Milken was just starting to build the high yield market. So the credit market was mainly the banks and the life insurance industry. But the important thing is that a lot of people managing businesses were given significant equity stakes for the first time, and I think that was a major contributor to the success of LBOs in the '80s.

The transactions we did in those days were also highly structured deals; they took a lot of time to do. The conventional wisdom in those days—and I think it was accurate—was that the value in those transactions was created mainly *at the time of the deal*. The value was created by introducing the incentives, by giving equity to the former managers in the conglomerates—or the successor managers in the family businesses—in most cases for the first time in their careers. For those people who had previously managed in conglomerates, it was no longer a matter of securing funds from corporate headquarters; resources were scarce and you had to invest them effectively. And if you made an investment, the payback had to be fairly quick and certain because much of the capital structure was senior bank debt that had to be paid back in five years. That was the basis on which the money was loaned.

But now let's fast forward to the 21st century and the world Alan described so well in his introduction. Our first fund back in 1984 was a $50 million fund, which took us nine months to raise. In 2005, the buyout portion of the private equity marketplace, excluding venture capital, raised a total of $82 *billion* in new capital commitments. It's a highly efficient and sophisticated capital market that is now divided into a bunch of different segments. There are megafunds like the ones raised recently by TPG and Blackstone. KKR raised a $13 billion fund this past year, or at least is closing in on that. There are niches, such as the mid-market and the small market, as well as sector funds that focus on specific industries. And there is a large and growing fund-of-funds business that can pick and choose among all these different sectors. This means that private equity, in the past 25 years—which is a remarkably short time, not much more than a generation—has become a very large and active and efficient capital market.

The question that arises today is this: How do the private equity firms take these resources that they're all accumulating and make them worth more than they were before? A couple of my colleagues and I recently heard Alan's counterpart at a major competitor predict that the returns in private equity would normalize at around seven percent in the future. That didn't make the business sound very interesting to us. But, if that's really the environment we're looking at, how can a buyout firm distinguish itself from its competitors?

And that's why I would argue that the contributions to value of today's buyout firm are somewhat different from the ones that Mike focused on. Giving managers a significant equity stake and using debt to force out free cash flow will continue to be important. This more efficient deployment of investor capital has been helped by having the tax rate on dividends at 15%, which encourages one-time dividend distributions that can be a valuable way of recapitalizing the firm. And, as Mike said, governing firms with small boards consisting mainly of large owners will also continue to be a major source of value.

But, as Alan and Steve also suggested, there are some relatively new sources of value, or at least a shift in emphasis toward what I like to call company building. Private equity today is increasingly much more than just having a lot of wonderful people on your staff who know how to buy and structure businesses. It requires an effort that says, "OK, we've just done a very thorough due diligence of the business, we think we know what we've got, and we've just closed the transaction. But let's forget that bit of history. Now we've got to sit down as a group and figure out what we as managers and owners want this business to look like going forward. We have to plan that methodically. And once we have agreed on the plan, we have to hold ourselves to it. We're going to measure our performance regularly and, when necessary, we'll make changes in the plan. What's more, we have to recruit the people we need to execute our plan. (I've never seen a business that had all the right people in it.) And we may have to be fairly ruthless about the wonderful person who's been with the company and helped it get to where it is, but who doesn't fit the execution of this plan—because that's what we are here to do. Everybody has to understand the game plan and the rules of the game."

So, again, you have to understand why you think you have a fundamentally good business, why you think you can improve its performance, and why you think you can sustain and keep building on those improvements. I should add that sustainability of performance in the 21st century is very difficult. Competitive information travels so quickly, and innovations can be copied so readily in so many different parts of the world, that the fact that you are a good business is yesterday's news. It's your ability to continue to be a good business that is the critical skill. It's effective management processes over and over again, and it requires continuous monitoring.

Let me also mention that we run our board meetings in two buckets. We don't talk about financial information until after we've had an afternoon talking about how the business is working. We discuss questions like: How are the problems with the customer relationships we all learned about in the planning process getting resolved? Who'd we lose? Who'd we gain? How'd we do it? How much of it was price? How much of it was competitive advantage? What are we doing to continually enhance that? Will it take capital? These are the primary issues that we're dealing with when we get together. The financial information is just supposed to provide a check on the business. And if the information doesn't mirror the business reality, we all know that it isn't right; it isn't measuring what's going on in the business. But you won't know that unless you spend time asking all those other questions first.

So that's the process that we go through, and that your management teams have to put themselves through, in order to get the continuous improvement we think is necessary to add value today. It's a continuous process of learning how we can do things better. For example, at the beginning of this decade, the main focus of companies that made things was on taking out costs. And people forgot how to market in those sectors. But I think we're now rediscovering how to market. We have a lot of new tools to use in marketing, and there's an abundance of information. A big part of our job will be to bring all of the new tools, technology, and human capability to bear on maturing businesses to make them better. The firms that succeed in those efforts will differentiate themselves.

Jones: Carl, you emphasized the importance of getting the right people. How important is it to go far down into the organization in aligning incentives? In other words, there's a CEO and then there's a whole group of people down below. How important is it to push incentives down into the organization?

Ferenbach: That decision has to be driven by the culture of the organization. I don't think you can create a collaborative culture inside a hierarchical organization just by giving a lot of people equity. In fact, I've seen attempts to do that fail. On the other hand, you can clearly destroy, or fail to create, a collaborative culture by not spreading ownership widely enough.

The general trend—which is consistent with our preferences and values—is toward collaborative organizations and structures. We don't like hierarchical structures. But that doesn't mean that we won't get behind strong and somewhat hierarchical leaders who are also great business builders.

Jones: Does collaborative mean five people or 50?

Ferenbach: It can mean either. It means that your culture is as inclusive as your problem solving. It involves a lot of input, which therefore takes time. People must come to a common understanding. When they do, they can usually execute very effectively because there are not five layers of management between where the decision gets made and where it has to be carried out. That will generally lead us to prefer 50 people over five.

Boards Public and Private

Jones: Thanks, Carl. Meyer, I want to bring you into the conversation and take advantage of the fact that you serve on the boards of both public and private companies. This gives you a great perch from which to view the agency problems in public corporations that result from misaligned incentives and how private equity firms attempt to deal with them. Given your experience in sitting on those two different kinds of boards, do you see a meaningful difference between public and private companies in how they behave and respond to incentives?

Meyer Feldberg: I would guess that, in the past 20 years, I've served on as many as 15 different boards. Half a dozen of them have had controlling shareholders, including KKR, Welsh Carson Anderson & Stowe, and MacAndrews and Forbes. In some cases, I have served on boards of companies that were public when I joined, but were then taken private—and later taken public again. Most of my observations this morning will reflect my experience serving on these boards.

Let me start by saying that there are major differences between the legal and regulatory requirements for public companies that are controlled by private equity firms and those that apply to "non-controlled" public companies. And in my experience—and no doubt partly as a result of the above differences—there are also significant cultural and behavioral differences between controlled and non-controlled boards.

When I say "controlled companies," I am talking about firms that are controlled by private equity firms or one of their funds, or by a single individual representing one of those firms who functions as a controlling shareholder. In my experience, the boards of controlled companies have a split personality. Such boards have independent board members, and they have management and investor-affiliated, or what are known as "interested," board members. Though there are some matters on which the entire board acts, in most important corporate decisions the board acts only after the board members representing the controlling shareholder have met and discussed the issues and reviewed the desirable outcomes. Private equity firms tend to exercise considerable operating control over their portfolio companies and so their board representatives typically meet with management and each other on a regular basis. The full board may meet six to eight times a year, and the Audit, Nominating, and Governance and Compensation committees often meet even more frequently.

Thus, although there is active, full-board governance on some issues, that system exists alongside the reality of management and the controlling shareholder working together to further the interests of the company and the fund. Both Mike and Steve commented earlier

The due diligence process conducted by most private equity firms when buying companies is of a different order of intensity than what goes in most public company acquisitions. And judging from my own experience, I would say that intensive due diligence continues to be conducted by the controlling board members well after the deal is closed. Given their incentives, controlling board members just spend far more time and energy monitoring operations and performance than their "non-controlling" counterparts.

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that the due diligence process conducted by most private equity firms when buying companies is of a different order of intensity than what goes on in most public company acquisitions. And judging from my own experience, I would say that intensive due diligence continues to be conducted by the controlling board members well after the deal is closed. Given their incentives, controlling board members just spend far more time and energy monitoring operations and performance than their "non-controlling" counterparts. In fact, it is entirely possible that the directors representing the private equity firm will meet with the CEO and other members of management every couple of weeks for years.

Although these meetings will typically involve mainly operating and strategic issues, they are sometimes used to review governance, audit, and compensation issues that eventually find their way onto formal board or committee meeting agendas. In recent years, controlling directors have become increasingly sensitive to governance issues and have attempted not to circumvent—or be seen to circumvent—the formal board process or its governance. As evidence of this concern, controlling directors seldom meddle in the work of the audit committee. In my experience, they have often been delighted to have independent directors assume responsibility for the audit.

But the compensation committees of controlled companies are a different matter. As a number of people have already suggested, the compensation package and incentive structure for CEOs of controlled companies are heavily influenced by the controlling directors. They are usually the driving force in appointing the CEO and in setting his or her compensation package. And although the outcome of this process is ultimately reviewed and approved by the compensation committee and recommended to the full board, the reality in controlled companies is that the controlling shareholders make the key compensation and hiring decisions.

At the same time, however, many controlled companies now have independent nominating and governance committees. Controlling shareholders are generally anxious to have governance conducted in a transparent fashion, and independent directors tend to exercise considerable control over nominating and governance. Nonetheless, the nominating and gover-

It doesn't take much time for anybody who's worked with a public company to realize that there is often a large information gap between what the CEO knows and what investors know. One of the strengths of private equity is its emphasis on long-term decision-making, and it is the much smaller information gap in private equity-backed companies that helps make this emphasis possible. The boards of private equity-backed companies, as the economically motivated representatives of the investor base, make it their business to know as much about the prospects and opportunities of the business as the management teams that run them.

John Moon

nance committee on some boards where I've served is in fact called just the governance committee—which tells you that the controlling shareholder has not been prepared to cede the authority to nominate or appoint new independent directors.

But, again, there's a lot of discipline in the private equity process. And to reinforce that point, let me conclude by coming back to the statement made a few minutes ago that, in the private equity business, you are only as good as your last fund. A private equity firm that has had five successful funds in a row followed by a failure with the sixth will have difficulty raising a seventh. And two failed funds in a row may essentially take that firm out of the business. So it's an unforgiving marketplace. And this takes us back to the point where Mike started, which was the importance of the discipline of having to give the money back at the end of a finite fund life—and then trying to raise it again.

The Case of Metalmark Capital

Jones: That's right. Having to raise the capital again is a critically important driver for the funds. Let's now hear from John Moon of Metalmark Capital. John, how do you try to distinguish yourselves as investors? We've talked about financial engineering, and about Steve's concept of "financial and governance" engineering. We've also talked about the increasing use of operating partners, either on staff or being brought in from the outside to run companies. When you look at a business at Metalmark, what makes it an attractive investment for you?

John Moon: I'm going to begin by drawing on a couple of concepts that have already been introduced. The due diligence process that Meyer just mentioned—and, more generally, getting the most information possible about the companies you invest in and understanding the industries in which they operate—is critically important to success. We at Metalmark do this by bringing to bear our own experience as well as the experience of a network of executives who have worked with us, some for over a decade. I agree with Mike's statement earlier that, when a company is taken private by an experienced private equity firm, the due diligence process probably unearths more information about the company than has ever been known, or assembled in one place. And as Meyer just suggested, the fact that the controlling board members meet with management every few weeks means that the initial due diligence is just the beginning of an ongoing and collaborative process, one that continues as long as the private equity firm holds a stake.

The second critically important aspect of private equity is establishing the proper management incentives, which Mike, Steve, and Carl have all commented on. As Mike has been telling us for over 20 years, converting professional managers and board members into committed owners can lead to amazing transformations in management morale and motivation. We're big believers in providing an opportunity for managers to share meaningfully in the wealth they create.

But, on top of the better information and the stronger incentives, what may truly be unique about the private equity industry is the extent to which it practices what it preaches. First, consider the norm in the conventional asset management industry. Although the investment track record of a conventional, long-only money manager is very important in attracting additional funds—and presumably influences the manager's long-run compensation—the link between fund returns and the manager's compensation is fairly indirect. By contrast, the economics of private equity firms are directly linked to the investment returns to their limited partners. The customary 1½% management fee and 20% carried interest are an absolutely critical part of what we do; the direct pay-for-performance element built into this arrangement represents a sharp contrast to the incentives facing mutual fund and other conventional money managers.

Through carried interest, the general partners of private equity firms are highly motivated to deal with the difficult corporate governance issues that go unaddressed in many large public companies. In their path-breaking paper on agency costs and corporate governance, Mike Jensen and Bill Meckling identified what economists now refer to as the "agency problem." Practically speaking, the problem can be described as follows: How do you get a bunch of small investors, each with highly diversified portfolios, to take the time to ensure that managers do the "hard things" required to maximize value in the companies they invest in? Small investors don't have much incentive, or much of an opportunity for that matter, to really work with the management teams they back. Even the few who do serve on boards don't really have much incentive to truly challenge management. As a board member, the easiest thing to do is to go along with what the chairman recommends.

Private equity firms are quite different: First of all, private equity investors make sure that the economic incentives of the CEO and the executive teams are aligned with their own, and therefore with those of their investors.

Jones: John, let me stop you there. What is your response to the question that I asked Carl a few minutes ago? How far down in the organization does the equity need to go to be effective?

Moon: The more time I spend with management teams, the more I think that the right answer from an economist's perspective—and this is really nothing more than common sense—is that the equity should be pushed as deep into the organization as there are people who "move the needle." And that will differ depending on what industry we're talking about. Having said this, I would also say there have been some examples of great CEOs who embody virtues that can't quite be quantified in economic terms; they have been much more generous in spreading the wealth than economic theory might prescribe. Some of the best CEOs will sometimes do things that may not look rational from an investor's perspective, but create a tremendous amount of employee loyalty, which can translate into real value creation.

So, how far down does the equity need to be pushed into an organization? It should be given to those who can move the needle in proportion to how much they can move the needle.

Jones: And getting the organizational incentives right is part of the value that the private equity owner brings to the deal, right?

Moon: That's part of the value added. Again, as Meyer was suggesting, a critical part of the private equity story is bringing to bear a set of distinctive skills that translate over time into a track record of success and, ultimately, a positive reputation for the buyout firm. It's something that has not received much attention in academic research until quite recently. But, as the work of Steve Kaplan and others suggests, experienced investment teams in private equity with a superior historical track record have delivered consistently higher average returns. That consistency is harder to find in other asset classes, such as mutual funds for instance.

The general partners of a private equity firm are typically in the boardroom, alongside their highly motivated industry partners, actively contributing to the decision-making process. The fact that 20% of the investment value created comes back to the general partners gives people like us very strong incentives to measure and monitor performance and make value-maximizing decisions. And, to come back to Meyer's and Mike's point, if portfolio companies fail to add value, returns will be low and limited partners will be disappointed. Eventually, these firms will have trouble raising capital for their next fund. The directors of most public companies don't have such concerns.

The Growth Side of Private Equity

Jones: Thanks, John. Now, let's bring our other two practitioners, Cary Davis and Brian Hoesterey, into the discussion. And let me warn you that I'm about to stereotype you both. Cary, your efforts at Warburg Pincus are focused primarily on technology and software companies, and the investments of your firm are concentrated in earlier-stage deals than the typical mature LBO firms that we have been talking about. By contrast, Brian's investment activity is in the mature, industrial-oriented sectors that we associate with LBOs. So, on the basis of just these two pieces of information, I'm going to assume that Cary will be telling us about the "new economy" side of private equity while Brian will be a spokesman for the "old" economy—and I haven't found an occasion to use these terms for quite a while.

Cary, how does private equity differ when your investment is more like venture capital than, say, the kinds of companies purchased by Brian's or Carl's firms? And how does the role of the private equity investor in such companies differ both from what the public markets do and from a traditional LBO governance model?

Cary Davis: Alan, you're right to say that our lens at Warburg Pincus is a little different from that of the other private equity firms represented here. Even though we call some of our transactions "buyouts," we see ourselves as providing "growth equity" and all our buyouts are focused on growth. My own focus, as you mentioned, is high-tech growth industries. And so some of what has been said so far about some of the more mature industries may be less applicable in my case. But there is also a lot of common ground. In fact, I would say that perhaps the biggest difference between our deals and Carl's and John's is in financial structure: our deals tend to be funded with much less debt than standard buyouts in mature industries. As a consequence, we probably face—and transmit to our management teams—a bit less pressure for near-term results than most LBO firms. But, again, the differences are more a matter of degree than kind. All the firms represented here face the challenge of showing period-by-period results while also investing for the long term.

When I was at Harvard Business School in the early '90s, the two most valuable classes I took were Mike's course on "coordination and control"—the CCMO course that Carl mentioned earlier—and Bill Sahlman's course on entrepreneurial finance. What those courses had in common was an intensive focus on agency costs—the loss in value in large organizations that results from the misalignment of incentives between managers and owners. I believe that the private equity industry has gone a long way towards solving that agency conflict, as well as the particular form of that conflict that Mike has called "the free cash flow problem," the tendency of managements in mature businesses to retain and then waste excess cash on low-return projects. The substitution of debt for equity in LBOs solves that problem by forcing companies to pay out the cash in the form of interest and principal.

The private equity model is also premised on the idea that everyone needs a boss, including the CEOs of public companies. And it's also important that people's goals, including the goals of CEOs, are consistent with their bosses' goals. In buyouts by private equity firms, whether they're start-ups or late-stage deals, the partners of firms like ours effectively become the bosses of the CEO. We have enough at stake, and are sufficiently involved in and knowledgeable about the business, to ask the hard questions and to have awkward and difficult discussions when we aren't happy with the way things are going.

But let me mention another kind of agency cost—one that, although I didn't

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Cary Davis

hear much about it at Harvard, I tend to hear all the time in my conversations with the CEOs of public companies that want to go private. When a CEO in the technology industry comes to me and says, "We want you to take us private; the market doesn't appreciate what we're doing," I'm usually skeptical. My first reaction is, "Why should I believe your performance is going to improve when you're no longer a public company? What can you not do as a public company today that you could do if you were private?"

The typical answer I get—which I don't find very persuasive—is that the need to meet quarterly earnings targets prevents public companies from running their businesses for the long term. And if they were to go private, they would invest more in the firm's future. Now, it's true that when we take companies private, we often take steps right away that reduce revenue and earnings. For example, we might persuade them to get rid of ten percent of the least profitable revenue. And we often begin to make some investments in the business that have been avoided for a long time for fear of the effects on earnings. And, by the way, these investments are designed to pay off during *our* time horizon—that is, during the five- to seven-year period after which we're looking for liquidity.

So, some of the increase in value added from a private equity firm comes from this lengthening of management's time horizon, and the ability to create profitable growth and value that results from it. But, as I suggested, I'm still a bit skeptical about this. I'm not completely convinced that public companies couldn't do this on their own—and without going private. Why can't they invest in their future and make all the right business decisions—and then improve their communication with investors?

Jones: Cary, you describe Warburg as growth investors. But I wonder how different that is from what other firms are now doing. Both Carl and Meyer have talked about a shift in focus over time from cost-cutting to growing the top line. And it's clear that such growth is critically important to the investments that you make in technology and related investments. But does growing the top line require a completely different incentive and governance system from the one used to increase value in more mature, slow-growth industries?

Davis: Well, every industry has its challenges. But even in businesses focused on cost cutting where top-line growth is challenging, we have found opportunity in the fact that fundamental investment has been starved to meet quarterly targets. And, in some cases, we have even succeeded in accelerating cost cuts by making investments in IT and changes in the supply chain—and just by continuously questioning the way we do business on a daily basis.

If you think about the kinds of companies we buy—mostly divisions of public companies and mid-sized private firms—it's clear that a major part of our value added is to provide a set of skills and experiences that they don't already have. We are helping them to do something that they couldn't or won't do on their own. Sometimes it's by changing the management team. But most of the time it's by making the existing management team better.

Brian Hoesterey

Back to the Old Economy: The Case of AEA

Jones: Thanks, Cary. Now let's turn to Brian Hoesterey and AEA Investors. Brian, AEA was really one of the pioneers in taking advantage of experienced operating partners who sat on your advisory board for a long time and who have been instrumental in a lot of the things that you've done. As you think about the value added by improving operations—looking at operations differently and changing the way the people run the business—how important has the role of the operating partner or partners been to the success of the firm?

Brian Hoesterey: AEA was started in the late '60s, when our investors were primarily wealthy industrial families from around the world and recently retired CEOs of Fortune 100 companies. Although our investor base has changed somewhat over the years, these kinds of investors are still very important to us. Today we probably have 60 individual investors who are either former or current CEOs, or members of leading industrial families throughout the world. And to that group of investors we've also added a select number of institutional investors.

In the current environment, there is more competition to recruit those former CEOs. A lot of other private equity firms have decided that they like our model. And as a result, we're now competing for top managerial talent with perhaps not the full list of 2,700 firms that Alan mentioned, but certainly a formidable group of high-quality private equity firms. We all want the best people to help add value to our companies. Attracting and motivating these people has become even more difficult because today's CEOs come out of the companies they've run with significant savings from their earnings as a CEO; they're much better endowed than in the past. But, even with the increased competition, we have continued to add former senior management to our investor base and use them to help create value through improvements to the operations of our portfolio companies.

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As Mike pointed out earlier, our collection of companies and their assets makes us look a lot like a conglomerate. But we're able to get most of the benefits of the conglomerate structure—the ability to leverage the firm's general management skills, network of relationships, and knowledge base across a variety of businesses—without the loss of focus and accountability that seem to drag down most conglomerates.

First of all, between our investors and our offices, we have a global footprint. We can take a mid-sized U.S.-only business and share that lens with them. We can help them understand their need to think about what's going on in China, or about growth opportunities in Eastern Europe. It's very difficult for the CEO of a mid-sized U.S.-based or European-based company to get that global perspective. They're very busy running the business. We can help them by drawing on our own networks of professionals, investors, and outside resources. After all, we have a much larger base of investments to spread such costs over. They can take a piece of that insight instead of having to build their own infrastructure.

And, finally, as Cary was just saying, we can provide them with the breathing room to invest for the long term. We take the shackles off. We say, "Don't worry just about the next quarter or the next year. If you have investments that will have a big payoff in three to five years, go ahead and make them." And that's something that I think private equity is able to do that the public market investors either can't or won't do.

In fact, as Cary was just suggesting, I think private equity may provide the optimal balance of some time pressure with freedom from quarterly earnings and a really short-term perspective. Most of our investors are IRR driven, some more so than others. But, at the same time, I think ours are actually less so than some of the traditional institutions. All of our investors, however, expect to get their capital back after a certain period of time, whether it's two years or seven years. This creates a sense of urgency and moderate time pressure. Many family-owned or privately held companies don't feel any such pressure at all. The attitude in such cases is, "We've owned this business for 50 years, so we can think very long term."

Though long-term thinking is good, you also need some short-term catalysts and pressure. We will say to the management team, "Okay, that's great. But what are we going to do in the next year to get where we want to be in three to five years?" And in this sense, there are some real benefits to a discipline that says, "In five to seven years, we're going to have a day of reckoning."

So our approach, then, is to say to management, "Let's think long-term by all means. Let's not worry about the next quarter or so. But at the same time, let's have well-defined goals over that time period. As long as we've mapped out a course of action that gets us to our goal, and as long as we're meeting the milestones that we've jointly agreed to, we're willing to forgo some of the earnings gains early on to invest in the future."

As already mentioned, a key element in our success has been our ability to recruit help from outside our firm when we think it's appropriate. We believe that our investor base is very good at board-level governance and at helping us answer some very key questions in due diligence. But since many of these investors are not going to be there overseeing the company day in and day out after the deal closes, we often supplement this by bringing into AEA full-time professional operating partners—people who, as I said earlier, have been CEOs of very successful businesses, who have moved around and seen a lot. And they serve as day-to-day coaches for the CEO. They can help guide the CEO by saying, "I've seen this in six different situations. Maybe you should think about the following." Or maybe the CEO needs a little more confidence to generate change quickly, and he or she will have a thought-partner there to say, "It's okay to take risks; you can generate that change; you can move a little faster than historically the organization is comfortable moving." Or they might say to the CEO, "You need more talent here. Let's face it; this team isn't going to get it done. So why don't you put them on notice and ask for an improvement plan? Or if we can't come up with a plan for improvements, then how about a succession plan?"

I think it's in these kinds of situations that we can really add a lot of value. Being CEO of a company can be a pretty lonely position. There are very few places to turn for someone who provides an objective sounding board and whose interests are aligned with yours. And I think private equity, done in the right way, can provide that sounding board and can make CEOs more effective than they would be on their own.

Of course, one of the advantages of being the controlling investor is that, if the CEOs don't get better, you can change them. That's a major benefit of private equity over public ownership, where the change process takes much longer. And the CEOs who work for us understand this very well. That's an important part of the deal.

Jones: Nothing concentrates the mind like the prospect of a hanging.

Part II: Lessons for Public Companies

Jones: Now that we've heard from everyone, let's turn to our second major question: What can public companies learn from the successes of private equity? And since that's kind of a large question to get our arms around, let's start with a more manageable version of that question: In view of the gains to management teams as well as investors from going private, what's keeping more public companies from doing it?

It's clear that the role of private equity has exploded in the financial marketplace. Everyone seems to know about it. Three weeks ago, the term "EBITDA" was not only mentioned, but actually *defined* by a character on "The Sopranos"—an event that may turn out to be the high water mark of the private equity movement. An appreciation of cash flow has found its way into the popular culture.

We all seem to agree that private equity provides a potentially valuable discipline on corporate management. And on top of the benefits of its management and governance model, there are other reasons why companies shouldn't be public. One is the costs of complying with Sarbanes-Oxley. Another is the shift in the Wall Street research paradigm such that many small and medium-size companies are no longer being covered as public companies and therefore, I would argue, don't really have access to the public equity market.

Mike, let's start with you again. Why haven't we seen more public companies go private?

Jensen: I can't answer that question, or at least not in a way that will satisfy any of us. We talked earlier about the fact that there are two basic ways to get public companies to maximize value. They can either go private, or they can take a number of steps that make them look and act more like companies under the private equity model.

Some public companies have gone private, but many of them tend to come back to public ownership in one form or another. And other public companies—and I think it's an increasing fraction of the total, though Steve may contradict me on this—have gone private and stayed private over time. But what surprises me is that so few public companies are actually taking advantage of the new management model that's embedded or implicit in the private equity movement. As we heard from people around the table, that model has a number of different aspects and features. But I think it's possible for public companies to take almost *all* of the major competitive advantages of the private equity sector and implement them in one way or another *without actually going private*.

For example, in a wonderful *Harvard Business Review* article called "Reforming the Corporation From Within," Bennett Stewart shows that, through the use of what he calls "leveraged equity purchase plans," or LEPPs, public companies can simulate the benefits of both leverage and equity ownership without imposing financial risk on the corporation itself. Using these LEPPs, which are basically stock options with exercise prices that go up each year at the cost of capital, companies can get virtually all of the incentive benefits for individual managers or groups of managers that you get by levering the company and taking it private.

Stewart also mentions a number of ways to restructure public companies to make them operate more like the private equity model. For example, through transactions such as spin-offs and partial IPOs, diversified companies can create a network of businesses, each with its own stock price and capital structure, under a single corporate umbrella—an approach that was pioneered with considerable success by a company called Thermo Electron in the '90s. And public companies with a big free cash flow problem should consider a major leveraged recapitalization, or what is sometimes called a "public LBO."

As one example of a public LBO, in the late '80s a packaging company called Sealed Air, whose CEO Dermot Dunphy had considerable experience as an outside board member of LBO firms, paid out roughly 90% of the company's pre-transaction market value as a special dividend. Since the market value dropped by only a small amount after the payout, it was clear that the company had created enormous value virtually overnight. And several years later, as if to see whether the market got this one right, my former colleague Karen Wruck produced a case study showing how this huge payout and change in capital structure led to dramatic improvements in operating and investment policies, which in turn resulted in large increases in value over the next few years.

But, again, the key is that you have to get top management and operating heads thinking of themselves not as running businesses, but as running governance systems that run businesses. To the extent you succeed, that would be a huge change. But very few companies have followed the course of Sealed Air or Thermo Electron. So, where I'm often left in trying to answer

The enormous growth in private equity raises questions that the managements and boards of public companies may soon find themselves addressing if they have not already: Is our company leaving value "on the table" in the form of excess cash and unused debt capacity? Is it possible that we would operate more efficiently, and be more valuable, in the hands of a private equity firm? And if we decide that we're more valuable as a public company, should we consider taking a page out of the private equity playbook and invite some of our largest investors onto our board?

Alan Jones

your question is this: Over and over again I seem to underestimate the time it takes for customs and practices—and perhaps even values or value systems—to change in ways that would take advantage of what are clearly superior techniques. That kind of change isn't happening in the head offices and boardrooms of most major companies. The companies have done some of it. Many companies have tried the heavy use of options and equities to motivate managers—although in many cases, they've misused these instruments. (And, just for the record, I have never been a big fan of conventional stock options; my preference has long been for Stewart's LEPPs with their rising exercise prices.) But the only explanation I can come up with for why more public companies have failed to adopt more aspects of the private equity model is inertia, the resistance of large organizations to change.

What's Gone Right with U.S. Corporate Governance

Steve Kaplan: I have a somewhat more positive view of changes in the U.S. corporate governance system over the past few decades. Mike and I are in basic agreement about most aspects of corporate finance and governance, especially about the value of the market for corporate control in disciplining management. But where Mike tends to see the glass as half-empty, I see it as half-full.

By most measures of governance and performance, U.S. public companies have improved over the last 25 years—and this reflects to some extent the companies' use of some of the elements of private equity. Management's equity ownership, for example, is much higher today than it was in, say, 1980. And that means that public company CEOs are much more sensitive to shareholder value than they used to be. As Brian just told us, the CEOs of today's public companies make a lot more money now than they did 25 years ago—and most of the difference has come from increases in the use company stock or options rather than in salary increases. Whereas a typical public company CEO in 1980 might have seen his wealth increase by just $1 for every $1,000 increase in company value, a typical CEO today would see an increase of $10—a ten-fold increase in sensitivity. The emergence of hedge funds and other active investors has further added to that sensitivity. CEOs care a whole lot more about their stock prices than they did 25 years ago.

Now, this is not to deny that there have been abuses of options—particularly in the late '90s, when we had the huge stock price run-ups. But it's important to recognize that the main, or first-order, effect of the large option grants since 1980 has been to align management's incentives with their shareholders'. And companies have attempted to limit those abuses by making options less liquid or shifting to restricted stock. For example, many companies today have ownership requirements that require their top executives to hold a certain amount of stock or options. Could public companies do better on this score? The answer is clearly yes. While executive stock options and restricted stock are less liquid than they used to be, many companies would be better off requiring them to be even less liquid.

Another indicator of the effectiveness of a corporate governance system is the extent of CEO turnover. I just finished a paper with Bernadette Minton that shows that, in the past ten years, both CEO turnover and its sensitivity to stock prices have increased sharply. The typical Fortune 500 CEO now can expect to keep his or her job for six years rather than the ten years that would have been expected in 1980. The message here is that the CEO job is a lot riskier than it used to be, suggesting that boards are doing a better job of monitoring and, when necessary, changing top management.

While some of the recent governance reforms are problematic—in particular, Section 404 of SOX—one reform has been beneficial: the requirement that boards meet regularly in executive session without top management. This increases board independence and arguably encourages public company boards to behave a little more like the principals of private equity firms.

There have also been some beneficial changes outside the firm in the market for corporate control. Hedge funds today are targeting public companies and trying to implement some of the same things that private equity investors would do. Now, I don't think that pressure from hedge funds is as constructive and efficient as giving complete ownership and control to private equity investors. But it pushes in the same direction.

The bottom line is that the forces that operate in private equity are also operating to some extent in public companies. They haven't gotten all the way there, but things are much better than they were 25 years ago. It's worth adding that these improvements in governance have coincided with a resurgence in the productivity growth of the U.S. economy. While it's impossible to say how much of an impact these improvements have had on productivity, it puzzles me that so many people can be so critical of U.S. corporate governance when our productivity has been so high.

Jones: Steve, do you think we need separation of the CEO and the chairman?

Kaplan: My sense is that by appointing a lead director who presides over an executive session, you almost get the equivalent of a chairman, whether you call him or her by that name or not. It's the requirement for the executive session that really makes a dramatic difference in the degree of independence that is possible. Five, six, or seven years ago boards rarely met without their CEOs and other insiders. But I think that directors find that when they're suddenly put into the executive session, good things can happen that weren't possible before. That's the conclusion that Warren Buffett came to in his 2004 Annual Report.

CEO Pay and Incentives

John Moon: There are limits, though, to what these boards can accomplish, even with executive sessions. And, Mike, let me offer up a hypothesis as to why public companies are so slow to change. The way I see it is that private equity provides both powerful management incentives and effective board oversight. Public companies have come a long way in getting the incentives right, but there's a lot more to be done in terms of governance and oversight.

A public company CEO who is motivated entirely by equity incentives *without much board oversight* is a dangerous CEO. It doesn't take much time for anybody who's worked with a public company to realize that there is often a large information gap between what the CEO knows and what the public knows. And if a public company CEO has strong incentives but not much oversight, you can never quite get those incentives quite right—in the sense that there will always still be some time horizon and governance issues that need to be addressed.

How do you make sure the incentives are working the right way? You need somebody who's also motivated to maximize value to work with the CEO to ensure that he or she does the right things for the long term. One of the strengths of private equity is its emphasis on long-term decision-making, and it is the much smaller information gap in private equity-backed companies that helps make this emphasis possible. The boards of private equity-backed companies, as the economically motivated representatives of the investor base, make it their business to know as much about the prospects and opportunities of the business as the management teams that run them. And I just can't imagine that ever being as true of a public company board.

Davis: I agree with your point that a CEO with powerful incentives and no oversight can be dangerous. But I think a big part of the danger comes from the design of the equity instrument—that is, conventional stock options. Many CEOs have gotten rich not necessarily because their companies have done so well, but because the incentive package that was put in front of them was not aligned with the values and interests of their shareholders. Building on Mike's suggestion earlier, I think we could correct this problem just by changing the way CEOs are motivated—that is, with payoffs that are tied to the stock price over a five-to-seven year horizon as opposed to the current stock price.

Now, I don't know exactly how to translate that into an incentive plan for public companies. But I would guess that it looks a lot like restricted stock that must be held for a long period of time. I think the widespread substitution of restricted stock for stock options—which I understand is the current trend—will lead to a major change in behavior inside large corporations.

Kaplan: While I agree that restricted stock will make sense for certain situations, options also will continue to make sense for many public companies. As a result, I don't think the fundamental problem is the *design* of the options or restricted stock. The greater problem comes from their liquidity. You can give management lots of options and restricted stock, but you've got to make sure they can't sell much.

Moon: Options can also create a swing-for-the-fence mentality. With restricted stock you create a sense of downside.

Feldberg: One of the problems with executive compensation programs is that when they are designed and put in place, they are based upon prevailing market conditions, including competition and the macro environment. Three or four years later, the environment changes and there are unintended consequences from the plan that was designed four years earlier. This does not necessarily mean that the plan was poorly designed or that bad judgment was applied; it's just that the plan takes on a life of its own and can be extremely difficult to adjust for changes in circumstances.

Kaplan: For all my optimism about the progress that public companies have made in recent years, there is one problem that I am concerned about—and it's another reason for companies to go or stay private. It's what I call the "demonization" of CEOs and CEO pay. The unfortunate fact is that public company CEOs can be pilloried *for doing too well*. If CEOs whose companies perform poorly get paid a lot, there's bound to be a lot of negative publicity—and rightly so. But CEOs who perform extremely well, and are paid accordingly, are almost equally likely to come under fierce attack; they become the bad guys.

There's a huge amount of confusion in the media about money and compensation, and little ability to distinguish concerns about the relationship of pay to performance from the general unrest over levels of pay. Take the case of Jim Kilts at Gillette. Kilts was a hero to Gillette's shareholders for improving the company, selling it to P&G, and markedly increasing the stock price both in absolute terms and relative to his industry. But he took a beating in the press for the amount of money he walked away with.

Davis: The media always get that wrong. And they treat annual option exercise as if it were all part of the current year's compensation.

Kaplan: That's right. This demonization of pay is one big reason why so many U.S. CEOs are going to work in private equity, where their pay packages tend to be both significantly higher and out of the public eye.

And if you think there is confusion about pay in this country, the problem is much worse in continental Europe. Take the case of Sweden, for example, which has a growing market for private equity. My understanding is that the social stigma that attaches to large payoffs for success has driven a number of talented Swedish executives to avoid listed firms and work for private equity-funded companies. And this is going on to some extent in the U.K. and, indeed, all over Europe.

Why Public Companies Don't Go Private

Ferenbach: I want to come back to this question of why we don't see more companies going private. There are two practical reasons. The first has to do with the price and the process. And by that I mean the price and process from the perspective of someone who wants to buy a listed company, and from the perspective of a seller that has to engage in a process of selling it to all potential comers. As a would-be buyer, you're entering into a process where the one thing you know on day one is that you are going to spend a seven-figure number just to have the ability to tell somebody what you think the company is worth. And if the seller disagrees, then somebody else has to pay a higher price—end of story. Well, unless you think you have a very high probability of getting the deal, that's just too expensive a proposition for most of us to engage in. So, from the buyer's perspective, taking public companies private is not very attractive.

As for the directors of the public company, their first reaction to an offer from a private equity firm is generally going to be, "Our stock price should be higher." They're typically not eager to hear from private equity people who think the company's already fully valued. Now, in some cases, an offer of a 5% premium over market may be enough to entice them to do a deal, but in most cases it won't. And to the extent buyers and sellers are likely to have different views about the intrinsic value of the firm, it may be hard to even think about doing a deal.

The second reason many companies don't go private is behavioral. If you are on the board of a public company that has clearly underperformed and then failed to reform in some way, it can be extremely difficult to say, "You know what? I think we should go private so that we're off the board and this company can have a governance structure that will make it a better company." Can you imagine a group of human beings sitting around a table having that conversation? Not likely.

Jensen: But why not, Carl? Why can't they see the benefit of changing the governance structure?

Ferenbach: People who serve on public boards tend to be successful people, but they also tend to know very little about private equity and how it works. And private equity people generally don't sit on public company boards. My point is that a public company director is not likely to say, "I've got a friend who's an investor in AEA." It just doesn't work that way.

Jensen: Well, I'm surprised it doesn't happen more often, given the potential gains from making these changes. To go back to what Steve said earlier, I agree that we have made some progress. But to me the glass is not half full; I don't think it's even ten percent full. And what frustrates me is seeing what I believe are these enormous gains that are possible.

Take the budgeting systems that are used inside many companies not only for planning purposes, but—in far too many cases—as the basis for performance evaluation and bonus awards. We all know that these systems are incredibly flawed, that they encourage people to "sandbag," to understate the true profit potential of their operation. And if we were honest with ourselves, we would recognize that these systems effectively pay people to lie about what they think they can do.

Private equity cuts out this mess just by separating the budget completely from the performance evaluation process. In place of the budget negotiation process in public companies, private equity makes one non-negotiable demand—generate enough cash to make your payments of interest and principal. And, as Carl explained to us, it is the board's job to see that the proper milestones are set up and met. If all this gets done, the big payoff comes in the form of the value of the equity at the end of the five- or seven-year cycle.

But Carl's right. From the viewpoint of the average public company board member, going to private equity is like inventing a whole new system. What I'm saying is that people in private equity know how to create structures that could do wonders for many of those companies, both in the short run and over the long run. But the people responsible for running or overseeing those companies refuse to see it.

So, there's this huge prize out there—the potential gains in efficiency and value from better internal control systems. And what I think Steve and I disagree about is perhaps two things: the size of the potential gains and how quickly they could be realized by changing corporate ownership and control systems.

Jones: I think we need some kind of outside catalyst to make this happen. One possibility is activist shareholders. Hedge funds may be playing this role today, and we're also seeing the reemergence of corporate activists like Carl Icahn and Nelson Pelz.

Ferenbach: There's another catalyst at work here in the form of good old-fashioned competition. There are a lot of private equity-owned companies that have gone public. And when they go public, they typically don't turn around and say, "The old public company governance system was really better, so I think I'm going to forget everything we've learned from being a private company." They generally continue to operate with somewhat higher leverage ratios, and higher than average concentrations of ownership, than their public competitors. And I think the overall performance of these "round-trip" public companies is also pretty good relative to their competitors'—although this is an area where we probably need more studies.

But this raises another interesting question, one that comes within the purview of regulators and even legislators. As a private equity owner, when one of your companies goes public, regulations and listing requirements force you to drop off all of the key board committees once your firm falls below the 50% ownership level. And when that happens, you tend to have one focus, and that's unloading the rest of your stock as quickly as possible. Such regulations, by effectively forcing large investors off of boards, lead to an inefficient form of governance. They are driving private equity capital out of public companies instead of encouraging it to stay. And so I think we need to find a way to make legal and regulatory changes, as well as changes in listing requirements, that would encourage large investors to continue to serve on boards of public companies. The current rules discourage the continued investment and participation of the investors who have been a critical part of the governance system that has enabled the company to perform.

Hoesterey: I think this catalyst issue is very important because when we look at public companies, we too are aware of the pitfalls that Carl mentioned—which is why we tend not to focus much attention on such companies. The cost of trying to get something done is too high, and the certainty is too low. And on top of this deterrent, public companies have this very difficult agency problem with the CEOs and their ability to control or just ignore their boards. Most CEOs are not eager to give up the freedom they have as the top executive of a public company.

So, although there may well be significant benefits for public company shareholders in allowing private equity investors to exercise some control over management—to force people to think about things differently—most CEOs are unlikely to see it that way. I think the very best ones do; they are able to visualize the benefits and would welcome the oversight and strategic advice coming from knowledgeable investors. But most CEOs are going to be reluctant to have a boss with real power and control. And until there's a major change in the governance structure of public companies, or the threat of some outside force materializes, I don't think that most CEOs will volunteer to make that trade.

How Big Will the Deals Get?

Jensen: I remember when it was considered inappropriate and ill-bred for the CEO of a Fortune 500 company to launch a hostile takeover. So the hostile takeover movement was started by a handful of unaffiliated corporate raiders, people like Boone Pickens and Carl Icahn and Sir James Goldsmith who were vilified by the press and public opinion—and, of course, by the Business Roundtable. And there was much the same reaction to the leveraged buyouts of the 1980s. But now that the resistance to both hostile takeovers and LBOs has largely disappeared, management buyouts of divisions of public companies have become a widespread practice—and even LBOs of entire public companies, though not very common, are socially acceptable.

But the critical step is getting the CEOs to understand that this can help their companies. Of course, not all CEOs will be invited to be part of these management transitions, but those who are will share in the gains. And if the past is any guide to the future, the vast majority of these new companies will end up adding value. The companies will grow and become more successful and influential. And that's why I object to Steve's statement that the glass is half full. Yes, there have been improvements. But my point is that these improvements come nowhere near what is possible.

And, by the way, I've been a big fan for years of splitting the jobs of the CEO and the chairman. And that is now beginning to happen. But that's nowhere near enough. Having an outsider or an academic like me as the chairman isn't the same thing as having Brian or Carl be the chairman. That's a totally different world, and we have a long way to go to get there. And I think we will. I feel a little out of character in saying this, but if you look at history, I believe there is some hope.

Kaplan: Mike, did I really hear you say that?

Jones: Maybe we should issue a commemorative coin!

But, Mike, let me ask another provocative question: Does size matter? In other words, have we reached the point where we can think about doing an LBO of a Fortune 200 company? The high water mark in this business was reached in 1989 with the purchase of RJR Nabisco by KKR for $25 billion. And we've recently begun to see deals approaching that size again, such as Tele-Denmark at $15 billion and SunGard at $11 billion. These were both "club deals" made possible by bigger funds and greater access to the leverage lending market. And my own view is that we will see the RJR record eclipsed within the next 12 months.

But, at what point do companies become so big that their boards feel completely insulated from the pressure for value maximization that either private equity or hedge funds bring to bear?

Jensen: Well, size does matter; it is still a deterrent to a takeover, certainly a takeover that requires significant leverage. But it's only a deterrent to somebody on the outside taking a company private. My point is that there are huge gains from leaving these companies public, and then turning upside down the way managements and their boards think about the governance structure and the management system. The model for doing that is the way Berkshire Partners, AEA, Clayton & Dubilier, or KKR runs their shop. And then we can figure out how to implement the important features of this model in Fortune 200 companies around the world. I don't believe, conceptually, that it's all that difficult, even with the behavioral problems Carl mentioned.

Jones: But that's exactly why I raise the issue of size, Mike. You are asking why public companies can't make these changes themselves. They have seen the playbook from the private equity firms. My point, though, is a little different—namely, that many public companies, having reached a certain size, appear to feel immune from both private equity and activist shareholders.

Ferenbach: I think that's true. And I also think it's not just inertia. There's an old saying that people are the victims of their backgrounds, and I think that is the case with many corporate board members. You become increasingly insular if you keep adding people with the same sort of experience. The people who could make the change are actually happy with the status quo.

Kaplan: Well, before we go much farther down this track, I want to emphasize what has gone right in recent years. First, as I mentioned earlier, is the productivity of U.S. companies. Over the last ten years, the productivity of the U.S. economy in relation to that of other developed countries has been nothing short of spectacular. So the economy clearly hasn't performed badly. And while governance may not be the most important cause of such productivity, we clearly have *not* had a governance meltdown.

The second important point is the rising pressure on corporate managements today—and it's being brought to bear on companies of all sizes. I recently heard someone say that 25% of Fortune 500 companies now have a large hedge fund investor, as defined by a 5% stake or $500 million of stock. And that is new and different. Also important is the 1992 change in SEC rules that permits different shareholders to coordinate their efforts to approach management and put pressure on companies. This rule change has clearly had a positive effect, allowing hedge funds to work with other funds and shareholders. And I think it will continue to encourage more activism of this kind.

So, these two developments alone—the productivity of the U.S. economy and the new forms of shareholder activism—suggest to me that important changes have been happening.

And, Mike, I certainly don't disagree with your argument that there are still major gains to be made. But I strongly disagree with your statement that *your* thinking has not had an impact on the behavior of corporate America. A lot of the beneficial changes in the past 25 years have come from some of the principles and practices you've espoused over the years. And undervaluing the changes we have accomplished has the effect of reinforcing what *I see* as the excessive and unwarranted criticism of the U.S. corporate governance system that has come with the recent corporate scandals. My point is that, when you take the long view, events like Enron and WorldCom are aberrations. And stressing the gap between what we've done and what is possible causes people to overlook our accomplishments.

My main answer to critics of U.S. corporate governance is that we have come a long way over the last 25 years. But, as you say, Mike, we still have a long way to go.

Hedge Funds, Private Equity, and the "Convergence" of Financial Institutions

Jones: Speaking of accomplishments, some people have suggested that the private equity movement has succeeded in picking most of the low-hanging fruit. Conglomerates have harvested divisions that don't fit their strategies and, Mike's comments notwithstanding, we've seen a good number of public-to-private transactions. So, on the basis of just this evidence, I would argue that U.S. corporations have in some measure responded to the private equity model of management and corporate governance, restructuring themselves without going private.

But my question is this: Can we now expect these events to be played out in Europe and Asia? The U.S. private equity firms clearly think so, since they started moving their people to Europe in 1997. And they're moving people to Asia now. What can we expect to happen in Europe and Asia, and does this movement of people signify that the low-hanging fruit's been picked in the U.S.?

Feldberg: I do think that the U.S. has done an excellent job in cost cutting and in driving up productivity levels. The big issue facing many industries now is how to drive top-line growth. The Europeans are also having a difficult time with top-line growth, but they still have cost-cutting opportunities and productivity gains ahead of them.

Jones: I agree, but it will be interesting to see how much of this can be achieved. The kinds of restructuring that we now routinely do in the U.S. are harder to imagine in France, for example. But how does all this now play out?

The other interesting debate today is whether or not big companies really understand the lessons of private equity. And, if they get it, to what extent will they act on it? I feel pretty strongly that we finally have a catalyst in the form of activists like hedge funds and old-fashioned corporate raiders. But are large public companies now willing to do what was unimaginable just four or five years ago? Are we on an arc that is going to continue for some time? Or is there something that's likely to change or redirect this?

Ferenbach: One of the impediments to change in the U.S. that we neglected to mention earlier is the great difficulty, under U.S. law, for a director of a U.S. company to feel comfortable having a conversation with a major shareholder. We've seen a number of our portfolio companies go public and then have large investors buy 10-15% ownership stakes and become very involved shareholders. They're not private equity shareholders, but they're smart and they're vocal, and the management knows they're there. And they have a view, particularly on compensation and the use of capital.

So that kind of dialogue is going on between management and the investors in some public companies. The board only hears about that dialogue from management. So it's a highly filtered conversation. Socially, we've had the view that we don't want to undermine the CEO—particularly if the CEO is also the chairperson—by allowing sidebar conversations to take place. People on the board are worried about inadvertently communicating inside information and thereby tainting the shareholders and themselves. But activist shareholders can be very public about what they want. And nobody misses Carl Icahn's point.

Jones: That's right. Even though he owned only about 3% of Time Warner, he commanded an extraordinary amount of attention. He didn't get everything he wanted, but he forced a change. One reason I'm so focused on the catalyst issue is that we've witnessed the ability of relatively small shareholders to shake things up. And, as Steve noted earlier, the ability since 1992 for shareholders to coordinate their activism has made a difference.

Ferenbach: Well, think about Blackstone taking a 3.3% position in Deutsche Telekom. Though they don't have anything like a controlling position, they clearly think they're going to have a meaningful impact on that organization.

Kaplan: I think this brings us back to Alan's earlier question about the limits to the size of private equity deals. My feeling is that we are not going to see deals much bigger than $25 billion. None of the buyout firms have enough money to commit much more than a billion dollars to a single investment. If you put four or five firms together in a club deal, you might be able to get an equity base of five or six billion dollars. And leveraging that up four or five times gives you a purchase price of $20 to $25 billion.

But, again, in the case of very large companies, what we are seeing is hedge funds—or in the case of Deutsche Telekom, private equity firms like Blackstone—taking significant minority positions. They are doing what Icahn tried to do at Time Warner. He went there and said, "There's a problem we need to fix." And if other investors agree, they will support him. If they don't agree, they won't—which seems to have been the case at Time Warner.

Jones: Some hedge funds are either considering, or already making, private equity-like investments. Do the hedge funds have what it takes to compete in private equity, or do the private equity firms have a competitive edge in terms of human capital and reputation that should keep the hedge funds from making major inroads?

Ferenbach: That's a very good question—one that we talk about a lot internally and with some of our investors—and I don't have a definitive answer. Some of our private equity brethren have gone the other way and diversified into the hedge fund business. I just mentioned Blackstone's investment in Deutsche Telekom, which is similar to a hedge fund investment. Another example is Bain Capital, which manages a very successful hedge fund. And we've asked ourselves on more than one occasion whether we should be running some kind of special situations vehicle. Each year we go through a winnowing process that begins with, say, 1,000 transaction opportunities and we end up doing an average of about four deals. If you have spent a lot of time and money on, say, 100 of those 1,000 possible deals, you end up with a lot of unused intellectual capital. And our thought is that perhaps we should put that to work.

The people who run hedge funds are asking themselves the same question from the other direction. They're saying, "We look at broad industry groups, and we have tremendous talent that we bring in to do research. Maybe we can find another use for it." And though the model of many hedge funds is to make a lot of relatively short-term trades, there are many other hedge funds that are asking their investors to lock up for two or three years so that they can make longer-term bets on corporate performance. And then they go out and make large, fairly long-term bets on individual companies. Today many of those hedge funds are asking themselves, "Well, if we can reach that level of understanding of individual companies, why can't we take that into the buyout market?"

Now, all this begs the question, "Well, if they came, would they succeed?" And the answer…

Jensen: The answer is no.

Ferenbach: Well, yes and no. There are circumstances in private equity—we would describe them as being "around the edges"—where the hedge funds' skills would serve them well. What hedge funds are good at is exploiting inefficiencies. So, to the extent that you can identify an inefficiency in the private market—and they are there to be found—hedge funds can be counted on to find and profit from them. The big problem, however, is that hedge funds generally require liquidity, and the private equity market is, of course, illiquid. That's one of its defining characteristics, and I think it could be a major barrier to entry. The hedge funds that are really intent on getting into private equity have to ask themselves: "Do we have the patience and the staying power to run this business as an owner for the next three-to-five years?" And that's where I think most hedge funds will come up short.

Jensen: That's right. If hedge funds really want to get into private equity, they have to learn how to run governance systems that run businesses. They would then stand a chance of being able to compete in this business. But that's a huge learning curve to work down, and I would be very surprised if that could be made to happen within a decade—if it ever happens. It's too big of a cultural gap. It reminds me of Salomon Brothers' attempt to break into the LBO business with their buyout of Revco in the late '80s. That deal—which is the subject of another case study by Karen Wruck—was an unmitigated disaster. It was a disaster from the beginning; and to compound the problem, the people who put the deal together had no idea that ongoing oversight and corporate governance were going to be required after the deal closed. They were basically traders who saw what they thought was an undervalued asset. And they and their creditors were taken to the cleaners.

Kaplan: I agree with Mike completely on this one. It's true that the hedge funds are now hiring some of the younger people who have spent three to six years in private equity. So they are getting some of the intellectual capital. On the other hand, it's instructive to think about what happened toward the end of the '90s, when there was an attempt at convergence between venture capital and private equity. During this period, some private equity firms moved downstream into venture capital-like technology investments. By and large, those investments didn't work. Enough money was lost that most limited partners today don't want to hear about private equity going downstream or VCs going upstream.

Jensen: And private equity is a lot closer to classic venture capital than it is to hedge-fund investing. What is the probability that the University of Chicago could be made to look like the Harvard Business School or vice versa? The cultures are both so strong that it would require many generations for that kind of change. I don't see it happening.

Kaplan: Neither do I. The two types of investing require very different skills and have very different liquidity characteristics. The only way to make them work together is to keep them separate—that is, create separate organizations with separate compensation systems but under the same corporate umbrella. Carlyle and Oak Hill, among others, have done this.

Ferenbach: One of the biggest impediments to the convergence of hedge funds and private equity is the difference I mentioned earlier in the regulatory burdens imposed on U.S. publicly listed companies. In the private markets, we have accounting rules to comply with, but we don't have any of the New York Stock Exchange, NASDAQ, or SEC regulations with respect to governance, nor do we have the Sarbanes-Oxley requirements for internal controls. As I said earlier, these regulations present a big problem for us when we take a company public; and if we could find a way to loosen them, private equity firms could play a more meaningful role in the governance of public companies.

Another recent development worth noting is something I would call the "institutionalization" of the most successful buyout firms and hedge funds. As they have expanded their fund sizes and the scale of their operations, they have been forced to develop management skills. And in the process, they have been developing an ownership class and mentality. The partners of the private equity firms participate in increases both in the value of their portfolio companies and in the value of the private equity firm itself. And as the firms expand and acquire franchise value over and above the value of their individual investments, the partners will show greater interest in how the firm itself is managed. At some point, some of these firms will even think about going public—but if and when they do this, their organizational design skills will really be tested.

I also think that we will see some convergence of the skills exhibited by financial institutions of all kinds. The financial institutions we grew up with in the 20th century that still remain—mainly a few big commercial banks—will gradually become history. At the same time, the much more free-form financial institutions that have already come to dominate certain markets—including, for example, some of the most successful private equity and hedge funds—may well end up becoming much larger and more diversified financial institutions in their own right. And among today's largest institutions, some investment banks are increasingly taking on the traits of hedge funds. Hedge funds and private equity firms will also be increasingly global in scope. And the winners, of course, will be those institutions that can attract and retain the best people.

There will also be a lot of differentiation, specialization in terms of industry, country focus, those sorts of things. But I think we're already well on our way to that. The private equity industry is still a very young industry. I started in the business a bit over 25 years ago, and I've seen most of these firms change dramatically just in that period. I think we should expect to see a lot more change.

Kaplan: My prediction is that, 25 years from now, there will still be hedge funds, and there will still be private equity funds and classic venture capital funds. Venture funds are very different from the others, and I don't ever expect them to converge with the others. And I also think that private equity and hedge funds will remain different businesses. They may be under the same umbrella, but, as I said earlier, you will have different kinds of people with different compensation and ownership structures doing the investing. And, in addition to some of the factors I've already mentioned, I feel pretty confident in predicting the continued existence of such specialized firms for one reason: Smaller, specialized firms attract very smart and talented people—and they will continue to do so.

Jones: I'm sure you're right about that. Well, this is a good place to end. I think this has been a terrific exchange, and I'll end where I started by thanking everyone for coming and participating. As I said at the outset, I have learned from a number of you over the years. And I've learned a lot from all of you today. Thank you.

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