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Public vs. Private Equity*

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Some executives may dismiss private equity as "expensive" capital while viewing public equity as a relatively "cheap" source of funds. Since returns on private equity have been higher than the returns earned by public equity investors, so the theory goes, the cost of private equity must be greater. But this logic misses the point. For both private companies considering whether to go public and public companies considering whether to go private (and all other companies in between), there is much more to making sound equity-raising decisions than simply comparing investor returns. *Who* provides equity capital to a company is as important as how much equity is raised. Both decisions can have significant ramifications for firm value.

As discussed in this article, private equity and public ownership represent very different packages of costs and benefits. When you do the cost-benefit analysis, public equity may not turn out to be as cheap as it seems. And, in some cases, the benefits of private equity may prevail. Only by recognizing the costs and benefits of each can companies make the value-maximizing choice.

Public Equity

The private equity market is dwarfed by the public equity markets. As of January 2006, the NYSE reported that U.S. publicly traded companies (listed on all exchanges) represented approximately $18 trillion in total equity value. By contrast, the total equity value comprising the private equity market is measured in the hundreds of billions of dollars. Textbook finance theory characterizes the public markets as highly efficient and very liquid. The public market represents the superset of all theoretically possible investors, and companies that are large enough to raise equity in that market are believed to be able to do so smoothly, at almost any time, and at a relatively low cost that reflects investors' ability to diversify their portfolios. Such, for instance, are the underlying assumptions of the Capital Asset Pricing Model. And in addition to the benefits of attracting a broad, well-diversified investor base, many executives believe that being public provides a company financial flexibility and credibility in the eyes of its customers, suppliers, and employees. What's more, for private companies, an initial public offering can represent an important milestone of financial success—for the company, its shareholders, and often the executives themselves.

But financially sophisticated executives will recognize that, for all its attractions, there are real costs to raising capital in the public market and to being a public company—and these costs can be substantial. Most executives are aware of the direct costs of raising public equity. The fees paid to underwriters, auditors, attorneys, and other intermediaries typically run from 3% to 5% of the gross proceeds of an offering for an already public company, depending on the size of the issuance among other factors. Compliance and investor relations efforts involve additional—and, with the introduction of Sarbanes-Oxley, growing—costs associated with having public shareholders.

But as large as these direct costs are, there are potentially much larger costs that are often overlooked. One clue to the source and size of such costs is the negative market reaction to announcements of seasoned equity offerings. The most widely cited academic study was authored by Paul Asquith and David Mullins from Harvard (at the time).[1] Their study and others like it find that the announcement of such an offering causes the average (unregulated) company's stock price to drop by about 3%—and, in some cases, the drop can be as much as 10% or more. While a drop of 3% may not seem like much, unlike the direct costs mentioned previously, this cost affects the value of *all* the company's shares.

To illustrate the potential loss of value, let's assume that a company undertakes an equity offering to raise about $100 million, which represents 10% of a company's pre-offering market cap of $1 billion. Assume also that management believes that the pre-announcement value of the firm, $1 billion, is also its fair value. In that case, if the

* This article draws on the author's previous article on private equity published by *Oil & Gas Investor*.

1. P. Asquith and D. Mullins, (1986), "Equity Issues and Offering Dilution," *Journal of Financial Economics*, Vol. 15, pp. 61-89.

stock price were to drop by 3% on the announcement of the offering, that drop would represent a $30 million decline in the equity value of the firm, and that $30 million loss would amount to *30% of the proceeds from the offering*! Effectively, a $1 billion company could expect to incur more than $30 million in total costs to raise $100 million.

If this sounds implausible, consider the market reaction to a high-profile equity offering undertaken by AT&T in 1983. When AT&T announced a $1 billion public equity offering in February of that year, it experienced a 3.5% drop in its stock price. That drop represented $2 billion in its market capitalization, and thus *200% of the amount to be raised*. Nevertheless, the company proceeded with the offering.

In theory—or at least in a world where well-understood companies were always correctly valued and managers could be counted on to maximize value—stock prices should not react negatively to equity offerings. And to the extent the announcement of an offering is a signal of promising new investment opportunities in need of funding, stock prices might in fact be expected to *go up*. Indeed, some research shows a systematically less negative reaction—and, in individual cases, a positive reaction—to offerings by high-growth companies.[2] But on average, empirical research has demonstrated that the market reaction to equity offerings is negative.

Public investors are skeptical providers of capital, and the more complex the company and its business plan, the more difficult and expensive it becomes to raise public capital, particularly equity. Hence investment bankers emphasize the importance of management's "credibility with investors" and its ability to communicate a "credible story to the Street"—without which the cost of issuing equity can be exorbitant. Public investors can be at a material informational disadvantage vis-à-vis the company's executives or other insiders, who are seeking to acquire capital at the lowest possible cost. Investors' natural response to this disadvantage is skepticism: If a company is raising equity instead of raising debt or relying on internally generated funds, management may believe the firm is overvalued (or at least not undervalued). Or worse, the firm may really need the funds because it is anticipating disappointing earnings from its existing businesses.

Indeed, investment bankers insist that the public markets can sometimes be "closed" to some companies. As prospects for a company become more uncertain, perhaps resulting from a period of financial hardship or a business transformation, public investors may grow wary and demand a meaningful discount to purchase new shares from the company. The company's willingness to accept a large discount to execute an offering may itself signal new adverse information about the company (or its management team), which in turn will cause a skeptical public to further discount the value of the company's shares. For some issuers in severe situations, this downward spiral of confidence can result in the market "failing." In other words, there is no price—or at least no price the issuer would accept—at which the market is willing to provide new equity.

These dynamics can be particularly acute in cyclical or otherwise volatile industries. Many executives believe that such industries present their most profitable opportunities during economic downturns—think, for example, of organic expansion, acquisitions, or even R&D—when project costs are lower and competition for opportunities less intense because even public companies find themselves capital-constrained. These periods are precisely when the public markets are likely to be costlier to tap or even closed.

Therein lies the paradox of public capital: it's most readily available when a company may not need it and least available when it does. Much like credit, it is cheapest when times are good and a company already enjoys high cash flow and expensive in downturns, when investment may be highly attractive but financial flexibility is constrained. In uncertain times, public investors are likely to provide capital reluctantly if at all. If financial flexibility is the key to capitalizing on opportunities in the long run, public capital may come up short.

Private Equity

The way in which the private equity market is structured and operates represents a stark contrast to the public equity market. Whether one defines private equity strictly as later-stage investments, which are typically control-oriented transactions involving mature companies, or includes early-stage investments by venture capital firms as well, private equity investors firmly believe that they offer a very different proposition from what is offered in the public market. Rather than simply offering capital in exchange for passive equity interests as traditional public investors do, most private equity investors (rightly or wrongly) fancy themselves as "adding value" to the companies in which they invest.

In contrast to most professional investment vehicles (with hedge funds representing the relatively small but growing exception in the public arena), the fortunes of private equity investors are tied *directly* to the success of their

2. See K. Jung, Y. Kim, and R. Stulz, (1996), "Timing, Investment Opportunities, Managerial Discretion, and the Security Issue Decision," *Journal of Financial Economics*, 1996, Vol. 42, pp. 159-185

investments and, hence, to the prospects of their portfolio companies. Whether it is a venture capital firm providing seed capital to a startup or a private equity firm sponsoring a going-private transaction of a Fortune 500 company, their funds are typically structured as limited partnerships where the private equity professionals serve as general partner (GP) of the fund. The GP's compensation is tied directly to the performance of the fund itself. In addition to being an investor in the fund itself, typically representing 1% to 10% of the total capital committed, the GP is compensated in two main ways: (1) an annual management fee, typically 1%-3% of the fund's commitments, which is expected to cover much of the ongoing expenses of running the private equity firm; and (2) a "carried interest" in the fund, typically 20% of the gains generated by the fund (usually only if the limited partners have received a preferential or minimum return, typically on the order of 8%-10%), which is shared among the partners and often the junior investment professionals of the firm. These funds typically have a finite life of 10 or more years, with the first five or six years representing the investment period during which the committed funds are expected to be invested.

The incentives of the GPs of private equity firms are thus quite different from those of managers of long-only mutual funds that invest in the equity of public companies. Whereas the carried interest provides powerful incentives to reward success in private equity investing, the vast majority of public equity is managed in funds solely compensated with a fixed percentage of assets under management, irrespective of returns. Strong performance is expected to grow the asset base and thereby yield larger fees, but this correlation is imperfect at best. And the compensation of individual managers, while loosely correlated with fund performance, is generally not nearly as sensitive to fund performance as the private equity model.

As previously mentioned, the exception in the public equity sphere is hedge funds, which have a carried interest structure similar to private equity funds. Indeed, the growth in the size and influence of hedge funds may be viewed in part as an interesting attempt to bring greater pay-for-performance into the public investing arena.

"Value-Adding" Investors

Recent academic research on the private equity market suggests that at least some investors appear to add value. In contrast to research from public equity funds, including mutual funds and even hedge funds, a recent study by Steve Kaplan of the University of Chicago and Antoinette Schoar of M.I.T. reported that, over long periods of time, private equity firms have produced average returns to investors (net of fees) that are roughly equivalent to the returns on public equities.[3] The study also showed, however, that private equity funds with a proven track record of success were significantly (in a statistical as well as economic sense) more likely to demonstrate success in future funds than funds managed by GPs without such a track record. In other words, the data seem to show that, in contrast to public equity investors *and* hedge funds, private equity investors demonstrate long-run, sustainable differences in ability and performance. Thus, in private equity, unlike mutual funds, past performance appears to have some predictive power.

This demonstrated difference in the persistence of the returns of public and private equity investors is not necessarily surprising. Consider the following: imagine two fund managers, one who invests strictly in public equity securities and one who invests strictly in private equity. Now imagine that both adopt a strategy of investing randomly (e.g., making all decisions, including what securities to buy, based on a coin toss). Studies have demonstrated that the public fund pursuing such a strategy will have as much difficulty *underperforming* the market as it will outperforming the market. The private equity fund will not be so fortunate. Indeed, the very idea of random or indexed investing in private equity is an ill-defined term since the investment activities of a private equity investor involve much more than whether to buy or sell, how much, and at what price. Regardless of one's belief about the degree of efficiency and liquidity of the public market, most agree that private equity funds operate in a market with a significantly lower degree of efficiency and liquidity. The skills necessary to succeed in the private equity market are arguably broader than those required to invest in public companies; and, as Kaplan and Schoar's results suggest, the variation in such skills among private equity firms appears to be much more pronounced.

Some corporate executives appear to recognize that not all private equity investors are alike. A study by David Hsu of the University of Pennsylvania reports that early-stage companies with multiple offers by venture capital firms don't always choose investors based solely on the highest valuation.[4] Rather, the companies select venture capital investors based on reputation and other considerations. My own doctoral research at Harvard found that even public companies, when issuing private equity securities (often called "PIPES" for Private Investment in Public Equity Securities), issued the securities to private equity investors at a *discount* to the prevailing market price, thereby effectively compensating them for some value-adding skill or

3. S. Kaplan and A. Schoar, (2005), "Private Equity Performance: Returns, Persistence and Capital Flows," *Journal of Finance*, Vol. 60, pp. 1791-1823.
4. D. Hsu, (2004), "Why Do Entrepreneurs Pay for Venture Capital Affiliation?", *Journal of Finance*, Vol. 59, pp. 1805-1844.

service. This discount is quite different from the standard corporate practice of issuing similar equity securities to other corporate (typically referred to as "strategic") investors at a *premium*. Perhaps even more surprising, these PIPES transactions were associated with a positive stock price reaction (of about 10%, on average), in contrast to the negative reaction to the typical follow-on public equity offering mentioned earlier.

Among professional private equity investors themselves, there is a very strong belief that at least some investors (a group which typically includes themselves) have the ability to add value to their portfolio companies. Private equity investors view themselves as more than just good analysts who "buy low and sell high"—and even more than hedge fund investors who buy underappreciated companies and short overvalued ones. Private equity investors view themselves as active investors who contribute complementary skills to the management teams and companies they sponsor. The best private equity investors are *strategic partners* with management in the value-creation process.

This difference can often make private equity capital from a *professional* source a superior choice for companies, even public companies, considering the range of capital-raising alternatives from various sources. Here are some of the ways in which professional private equity investors believe they add value:

Liquidity/availability regardless of market conditions. In contrast to high-net-worth individuals (so-called "angels" in the VC community) or even corporate investment fund affiliates, professional private equity funds are typically limited partnerships composed of highly credit-worthy investors (each an "LP")—e.g., pension funds, endowments and high-net-worth individuals—who have legally committed to provide funding upon some short notice period (typically measured in days) irrespective of market conditions. Therefore, while these limited partners of a fund hold a highly illiquid investment when they invest in private equity, their pooled (rather illiquid) LP commitments are precisely what provide the availability of private equity capital in difficult industry and market conditions.

In fact, private equity investors are often contrarian by strategy, investing more aggressively when public market appeal for an industry is low. At Metalmark Capital, for example, our experience has been that providing liquidity to companies in out-of-favor industries experiencing financial dislocation has been a particularly effective investment strategy.

An information-based model of investing. Whereas public offerings are undertaken through an SEC registration process and marketed broadly to the universe of potential investors who evaluate only publicly available information, the private equity process begins by targeting a small group of investors or sometimes even a single investor. These potential candidates are often selected by an investment banker intermediary or sometimes directly by the management team itself. The choices are made based on the industry and financial expertise of the potential private equity partners and the likelihood that they will be able to understand the company's operating plan and specific business issues (and be favorably inclined toward making an investment). This small group of potential investors is afforded significantly more information than what is disclosed in an SEC filing.

In the private equity arena, the very notion of publicly available information is not a well-defined idea. By its very nature, private equity investing requires extensive interaction with the executives of any company they are evaluating (in addition to other contacts who are knowledgeable about the business and industry in which the company operates). This process always involves due diligence of a business, financial, and legal nature. The process begins with negotiating and executing a confidentiality agreement that will govern not only the use of the information granted to the potential investors but may include other legal issues such as restrictions on solicitation of employees or standstill agreements that restrict trading in the company's securities, including any public affiliates. General business and industry-specific due diligence is quite comprehensive, often reviewing with a more discriminating eye information that has already been produced by third-party evaluators on behalf of the company.

For example, a financial review undertaken in a so-called "quality of earnings" report by independent auditors hired by the private equity investor is standard practice even when SEC-quality audited financials exist. And the due diligence process is often tailored to a specific industry. In the financial services industry, third-party valuation firms are often brought in to evaluate portfolios of financial assets even when auditors have been responsible for regularly testing asset valuations. In the oil & gas industry, private equity investors will sponsor independent reserve evaluations that seemingly duplicate work that has already been provided by the company's internal or third-party reservoir engineers. The due diligence process calls for critical examination of every piece of information that involves any subjective judgments that may materially impact the valuation of the company. Business experience and industry knowledge play key roles in the private equity investor's judgments as to what questions to ask and how the answers should influence valuation and negotiations. The ability to negotiate this complex process is a critical element of the ultimate success of a professional private equity firm.

While this process may seem burdensome, the rewards are clear for both investor and management team. The investors are better informed and therefore more confident in committing capital; a well-informed investor is a willing investor. Even in the public company context, the rigorous due diligence by experienced and reputable private equity investors serves as a positive signal to outside investors, who gain comfort from the due diligence process without necessarily being privy to its details. To the management team that can credibly communicate its vision, it can be the difference between a successful capital-raising, which enhances equity value for existing investors (and management), and a highly dilutive offering. Finally, as informed investors, private equity investors are better able to recognize and reward management performance, even in difficult industry conditions, and to serve as champions of the management teams they sponsor.

Greater incentives for management. The due diligence allows for a candid discussion of the business plan. As a key part of the investment process, incentive plans are structured or enhanced to provide significant sharing of the value to be created by the management team. Alignment of management and shareholder interests through significant pay-for-performance plans is fundamental to the professional private equity investor's investment philosophy.

These management plans offer significantly greater opportunity for wealth creation than the compensation plan of the typical public company, and the link between pay and performance is also significantly greater. Private equity gain-sharing arrangements can also be considerably more flexible. For example, plans can and often are structured to provide additional incentives for exceptional performance by a management team or, under certain circumstances, to deliver returns that are taxed as long-term capital gains as opposed to ordinary income. In my experience, discussions over incentive compensation prove far more pleasant, interactive, and productive than management teams seem to expect based on their prior corporate experience. It is often a great way for the private equity investor to establish goodwill and get the working relationship with the management team off to a positive start.

We don't view these negotiations as zero-sum games—and clearly they are not. Our approach is to create plans that align management's incentives with investors' in such a way that our success relies on management earning a substantial, and often life-changing, payout for themselves. After the negotiations are concluded, we will all be hoping, and working together, for these life-changing outcomes for the executives—and the higher the payoffs the better—since the payoffs from these plans are always tied to the actual amount of value created and delivered to the investors. Indeed, it would be inconceivable for us to undertake a transaction where the management team is *not* given these high-powered incentives. These incentive plans are essential to facilitating a frank and open dialogue between management and investors, and they serve as the foundation for effective corporate governance.

Superior governance structure. Large public investors, including most hedge fund investors, generally avoid board membership because it makes an investor an insider under SEC regulations. This insider status restricts their ability to trade shares freely, a status that is problematic for the public investor who puts a high premium on liquidity. Most public investors view selling out of their investment as their only practical response to dissatisfaction with a particular company's performance.

By contrast, private equity investors actively seek out board representation. Indeed, the essence of the private equity model is better-informed investors interacting with more highly motivated executives in a closer working relationship with more open discussion at the board level. In monitoring investments, private equity investors work with CEOs, effectively serving various capacities that range from executive coach to consultant to investment banker, providing ongoing advice, analysis, and, when necessary, additional capital. The interaction of private equity investors with management extends beyond periodic board meetings to frequent ad hoc conversations about strategic ideas or ways to build the company's network of relationships and managerial capital, often leveraging the investors' proprietary network of business relationships and experience.

In contrast, for the reasons mentioned above, public boards are usually not represented by key investors and generally have more members, which can create a tendency toward bureaucratic behavior. While it is not uncommon for such board members to hold stock or options in the companies they serve, such interests are rarely comparable to the economic stakes of the private equity investors who serve on the boards of their portfolio companies.

Smaller boards can produce less politics and more efficient decision-making. This view is supported by research by David Yermack of New York University that shows an *inverse* correlation between firm value and board size, even boards that are small by public-company standards.[5] Yermack reports that the reduction in firm value associated with doubling board size from six to 12 members is about the same as the drop in value that accompanies another doubling of board size from 12 to 24. The median board in his sample of public companies consisted of 12 members, a number that would be regarded as quite large for a private equity-sponsored company.

Complementary business skills. While private equity investors are quite careful not to micromanage their portfolio companies and try to limit their role to active board participation, there are times when it may be appropriate

5. D. Yermack, (1996), "Higher Market Valuation of Companies with a Small Board of Directors," *Journal of Financial Economics*, Vol. 40, pp. 185-212.

Case Study

Several years ago, when the public markets were absorbing the effects of the Enron scandal and the subsequent failure of several large energy companies, we at Morgan Stanley Capital Partners[6] were involved in a process to acquire the oil and gas subsidiary of a utility that was undergoing its own "post-Enron" restructuring. The underlying oil and gas assets of the business were quite valuable, according to independent reserve analysis. But, as a result of a prior effort to provide liquidity to its parent company, the oil and gas subsidiary had sold forward much of its expected production for several years to a third party for an upfront cash payment that was then paid to the parent as a dividend.

This transaction resulted in a business that, despite good long-term prospects, faced the prospect of negative cash flows for several years until the delivery obligations under the forward sale agreement were met and the company could again earn cash for its oil and gas production. As part of this process, the parent had entered into several arrangements to support the subsidiary's credit on behalf of the counterparty to the forward sale, including parent guarantees and the posting of surety bonds. The negative cash flows and the practical challenges of unwinding the forward sale or otherwise restructuring the business, when combined with the out-of-favor nature of the industry, made an initial public offering at an attractive valuation challenging if not impossible.

Market observers thus believed that this fundamentally sound business was more likely to fetch a handsome price for its parent through a strategic sale to another industry buyer that could see through the credit complexities and short-term negative cash flows. But shortly into the divestiture process, rumors began to surface that the logical industry buyers for the business had little interest due to the negative cash flows and complexity of the financial arrangements. According to investment bankers, the strategic buyers believed that acquiring a business burdened by a complex and volatile financial contract and the resulting negative cash flows would be difficult to explain to an already skeptical public market—one that was still reeling from the failure of Enron and the distress of other energy companies with complex financial arrangements.

Fortunately for us, two years earlier we had supported the former management team of the target business in a start-up oil and gas business, and our portfolio company, supported by our private equity fund, became a natural candidate to acquire the target business. After much due diligence on the underlying business, the true cost of the liability and the potential areas for operational improvement, we were able to negotiate a successful acquisition of the target business. As private equity investors with a committed private equity fund, we were able to acquire the asset at a compelling valuation without having to explain our rationale to wary public investors in a separate capital-raising process. We provided our management team with the capital that served as the equity for the acquisition and the credit support for the forward sale obligation and assisted in the very complex negotiation process required to close the transaction.

After the closing, we provided advice to management and monitored the activities of the business as active board members, working particularly closely with management to ensure that capital expenditures were made for the development of additional production to meet the company's obligations. Last year, after a significant improvement in the financial condition of both the business and the industry, we sold the company to an industry buyer at multiples of our invested capital, thus concluding a highly profitable investment both for our fund investors as well as the management team involved with the buyout. Also worth noting, the CEO of the acquiring company disclosed that his firm had participated in the original divestiture process, but like others, couldn't acquire the business at the time because of all of the complexities surrounding the business, despite its fundamental attractiveness.

6. Metalmark Capital is a spin-off of Morgan Stanley Capital Partners.

to take a more active role. Private equity investors bring a wealth of contacts that may provide potential suppliers, customers, or occasionally even additional members of management for a portfolio company. Private equity investors may also have relevant information or experience from other portfolio companies that can contribute to the managerial capital stock of the company. Many private equity portfolio companies engage in mergers and acquisitions as part of their business strategy. In such cases, private equity professionals are typically brought in to oversee third-party investment bankers, sometimes even serving as the bankers themselves—and the private equity investor's incentives are clearly aligned with the executives to undertake only value-enhancing transactions.

Do these differences translate into real value for shareholders? Studies from a number of different perspectives strongly suggest that this is the case. I've already mentioned the favorable stock-price reaction to PIPES transactions, which again are in striking contrast to the negative reactions to conventional public equity offerings. Steve Kaplan, in the first major study of the operating performance of management buyouts, demonstrated that public companies that undergo management buyouts show significant operating improvements after such transactions. In the venture capital context, William Megginson and Kathleen Weiss have shown that, when VC-sponsored companies choose to go public, such companies face lower costs in going public and receive more favorable pricing in the public market than a matched pair sample of non-VC backed IPO candidates.[7] These sponsored companies are also able to attract more reputable underwriters and accountants to undertake their initial public offerings. Megginson and Weiss interpret these findings as confirmation of the argument that VC investors play a certification role in the IPO process for the companies in which they invest. Certainly, this certification role is consistent with my own experience assisting portfolio companies in mergers and acquisitions and capital-raising activities.

PIPES: Private Equity in Public Companies

The benefits of private equity are not limited to private companies. Indeed, PIPES represent an interesting phenomenon in the "expensive" private equity versus "cheap" public equity debate. Why do public companies with at least theoretical access to public equity sometimes choose to raise private equity?

As noted earlier, unlike public equity offerings, stock-price reactions to announcements of PIPES transactions are on average positive (and statistically significant) for issuing companies. Studies have measured an average price response on the order of +10%. The favorable market reaction raises questions for those who argue that public capital is cheap and that private equity is expensive.

No doubt the certification role of the private equity investors plays some part in the positive reaction. The fact that (presumably) "smart" or at least informed money is willing to invest can be reassuring to less-informed public investors, especially in cases of great uncertainty. The perceived improvement in corporate governance through board participation by the private equity investor and the value-adding role as financial and business partner also likely play a role in the favorable stock-price reaction.

In Closing: Complementary Roles for Private and Public Equity

In sum, executives should reconsider the conventional notions of public and private equity and reevaluate the potential roles of each for their companies. The importance of public equity, particularly for very large companies and growth companies with large capital requirements, is indisputable. Active and liquid public equity markets are critical for capital formation and economic development.

What's more, there is persuasive evidence that well-functioning public capital markets are necessary to *support* the development of the private equity markets. Based on research showing that countries with well-developed public markets also have the most dynamic private equity markets, Bernard Black and Ronald Gilson have argued that public markets support venture capital by serving as an important means of exit for these investors in what are long but still finite-lived partnerships.[8] And, in this sense, the private and public markets complement each other.

But while many if not most successful companies aspire to public ownership, going public and raising public equity capital may not be the optimal solution for all of them. For mature companies with reasonably stable free cash flows, private equity can be the value-maximizing choice. Companies with credibility concerns or companies undergoing rapid change may also benefit from private equity investment. This may even be true of public companies undergoing difficult periods of transition and financial challenge, circumstances that may prove difficult for public investors to evaluate and monitor. And even some of the most successful public companies may at some point find that going private, or doing a significant recapitalization, could be the value-maximizing answer.

With a well-established public equity market and most industries enjoying solid near-term prospects, it is easy to overlook professional private equity. But conditions change, often rapidly. Developing a sense for the distinct costs and benefits of private equity today may be the key to securing the resources necessary to capitalize on the profitable opportunities of tomorrow.

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7. W. Megginson and K. Weiss, (1991), "Venture Capitalists Certification in Initial Public Offerings," *Journal of Finance*, Vol. 46, pp. 879-903.

8. B. Black and R. Gilson, (1988), "Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets," *Journal of Financial Economics*, Vol. 47, pp. 243-277.

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