If private equity sized up your business

by Robert C Pozen, Harvard Business Review, November 2007

Companies can benefit a lot by trying to understand how private equity firms create value. Public companies must ask themselves five questions:

- Have we left too much cash on our balance sheet instead of paying cash dividends or doing buy backs?
- Do we have an optimal capital structure with the lowest weighted after-tax cost of capital?
- Do we have an operating plan that will significantly increase shareholder value?
- Is the compensation for top executives tied closely to increases in shareholder value with penalties for under performance?
- Is our board of directors dedicating enough time to the affairs of the company and do they have sufficient industry expertise and financial incentives to maximize shareholder value?

Is there too much cash on the balance sheet?

Public companies tend to keep excess cash. They justify this as being necessary to protect the company during difficult times and for funding new initiatives/acquisitions. But so much cash may not really be needed. Moreover, excess cash can motivate management to take wrong decisions such as going ahead with overpriced acquisitions.

The alternative to keeping cash is paying dividends or doing buybacks. Buyback is the weaker of the two measures. Despite making announcements, many companies do not fully implement buybacks. In some cases, buybacks are done only to enable employee stock option plans. Buybacks make sense only if the shares are currently under-priced. The empirical results of buybacks being able to create value are mixed.

A better way to return cash is through dividends. The main argument against cash dividends is inflexibility. It is difficult to lower the existing rate of cash dividends. Ironically, this may be a key attraction for shareholders. Company management now becomes subject to the discipline of paying the same or higher level of cash dividends year after year.

Is the capital structure optimal?

Many executives argue against excessive leverage by stating that it will lower the credit rating, increase the borrowing costs and decrease the appeal of the company for investors. But this worry may be overdone. Investors in public companies have become comfortable with firms having higher leverage ratios. In any case, companies should do a careful analysis to arrive at the appropriate level of leverage that leads to the lowest weighted after-tax cost of capital.

Does the operating plan significantly increase shareholder value?

Value is created by focused investments, making the few key changes needed very fast and cutting back where required. Implementation has to be fast and effective. When there is a deviation from the plan, private equity firms act decisively. Cost control is also important. The company should compare itself with peers on metrics such as general administrative costs.

Is executive compensation tied closely to shareholder value?

The equity stakes of senior management in private equity controlled firms are relatively large. The equity incentives are offered to a much more select group of executives, chosen on the basis of their direct contribution to shareholder value. Public companies must reconsider the practice of spreading equity awards broadly across the employee population and instead concentrate the awards on the small group of executives who are the proven drivers of the company's performance. In case of private equity, executives receive their reward only when the private equity fund actually books the gain such as when the company is sold to a third party or when a public offering is made. Public companies must as far as possible use stock options and not restricted shares. In case of restricted shares, the penalty for underperformance is relatively small. Sometimes, stock prices may go up not because of the company's performance but because of a sharp rise in the general market. So, conditions can be placed on the exercise of the options, such as subject to meeting earnings targets. Companies should even think of adjusting the exercise price each year based on the movement of an appropriate index. Last but not the least, top executives must not be allowed to leave the company with large exit packages, despite poor performance.

Do directors devote enough time and have enough incentive to increase shareholder value?

Boards of private equity firms are small, with 4-8 directors compared to 10-14 for public companies. Directors in private equity firms tend to be people with extensive operating experience in the same industry. The “independence” requirement reduces the pool of experienced people available to public companies. Directors of public company usually meet 6 times a year with each meeting lasting one and half days on an average. Directors of private equity controlled companies spend 3-5 days per month and even more at the start. Directors of private equity companies are not only paid substantially more but they are also paid most of their compensation in the form of equity. Not surprisingly, directors of public companies operate in compliance mode and are more concerned with minimising downside risks than maximizing shareholder value.