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Private Equity Dynamics: Navigating Complexities in Corporate Governance

M.V.I. KHADRI[1]

ABSTRACT

Originally, private equity was established with the primary goal of optimizing the governance and operations of companies. The leveraged buyout, or the mere threat of it, played a pivotal role in reshaping management practices across a wide spectrum of U.S. companies by reuniting ownership and control. However, as competitive pressures have intensified, private equity is facing challenges in finding a significant number of underperforming companies to enhance.

This challenge is particularly pronounced in the case of U.S. public companies, which are constantly under scrutiny from activist hedge funds and empowered shareholders seeking any indications of inefficiency. In response to this shifting landscape, private equity is reorienting its focus away from governance reform. Instead, it is diversifying its strategies across various asset classes, including leveraged buyout funds, credit funds, real estate funds, alternative investments funds, and even hedge funds.

The shift is not without its complexities and potential drawbacks. Some of the newly adopted money-making strategies may be less likely to contribute to value enhancement compared to the traditional focus on governance and operational improvements. Furthermore, these diversifications introduce conflicts of interest and complexities that alter the traditional role of private equity in corporate governance. The historical governance advantage of private equity, ensuring that companies serve a single master, is now challenged as the master itself may have divided loyalties and attention.

With fewer opportunities for gains through governance reforms, private equity is discreetly distancing itself from the corporate governance revolution it once played a pivotal role in initiating. The industry's evolving strategies and expanding scope raise questions about its continued commitment to the governance principles that were instrumental in its early success.

Keywords: *Corporate Governance, Private Equity, Venture Capital funds, Leveraged Buyout.*

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[1] Author is a student at Damodaram Sanjivayya National Law University, India.

I. Introduction

Business school students in the United States often hear a narrative extolling the virtues of private equity ownership over the public-company governance model. The tale typically recounts the pre-1980s era, portraying public companies as plagued by entrenched, lethargic management, and passive shareholders powerless to intervene. Enter private equity, depicted as a saviour that reunites ownership and control, transforming inefficient corporations into lean, profitable entities. While this narrative may have been compelling in the past, the landscape has evolved, challenging the notion of private equity's unequivocal superiority.

Public companies have undergone significant changes. Institutional investors, the widespread embrace of shareholder value principles, and a thriving corporate control market have curbed unchecked managerialism. Hedge fund activists, especially prominent in the 2000s, held American management accountable and reshaped practices not only at their target firms but across the public domain. Although U.S. public companies are not flawless today, they can no longer afford mere gestures toward shareholder interests. The threat of activist campaigns has forced a shift in management practices, making improvements necessary.

Simultaneously, private equity's business model has transformed drastically. The traditional leveraged buyout (LBO) strategy, involving the acquisition of a public or private company, capital structure optimization, operational enhancements, and eventual sale or public offering, has encountered challenges. The governance advantages of LBOs, such as cost-cutting, management replacements, the disciplining effect of high leverage, and vigilant board oversight, are facing pressures. The landscape for private equity is changing as the newly reformed public companies offer fewer opportunities for gains through governance and operational improvements. Activist hedge funds and other institutional investors have already made substantial strides in this regard. Notably, studies indicating positive impacts of LBOs on firms' governance and operations often rely on data from earlier decades or foreign contexts, underscoring the shifting dynamics of the private equity landscape.[2]

Simultaneously, private equity is grappling with the challenge of identifying viable private targets for acquisition and enhancement. Large corporations are increasingly opting for growth through acquisitions rather than relying on organic expansion. This shift has led strategic

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[2] Martin Lipton, et.al, *Dealing with Activist Hedge Funds and Other Activist Investors,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 25, 2023), https://corpgov.law.harvard.edu/2019/01/25/dealing-with-activist-hedge-funds-andother-activist-investors-2/.

acquirers to swiftly snap up private firms that would have traditionally been ideal candidates for private equity acquisitions, as these companies seek capital. Additionally, the expansion of venture capital funds into non-tech sectors, prolonged retention of portfolio companies, and a growing comfort with debt financing are further diminishing the pool of potential targets for private equity. This trend is particularly evident in the technology sector.

Despite being flush with cash, private equity faces stiff competition, leading to soaring firm valuations and diminishing the likelihood of finding attractive targets. The abundance of capital in the market is impacting returns and raising concerns about the sustainability of private equity's success.[3]

Moreover, new money-making strategies within the industry are deviating from the traditional governance optimization approach, introducing conflicts of interest and complexities that reshape private equity's role in corporate governance. The governance advantage of ensuring that companies answer to a single master is becoming less straightforward, as the master itself may have divided loyalties and attention. With diminishing returns from governance reforms and increased competition, private equity is gradually distancing itself from the corporate governance revolution it once played a pivotal role in bringing about.

This article unfolds in three parts. Part I delves into the prime era of private equity's traditional strategy, emphasizing governance and operational optimization. Part II elucidates how competition from various fronts is steering private equity away from its historical governance focus. Finally, Part III provides a brief overview of how private equity has adjusted its strategies, highlighting the resulting complexities and conflicts of interest that cast uncertainty on its evolving role in corporate governance.

II. THE CLASSIC GOVERNANCE ROUTE: EMBRACING THE EPOCH OF GILDED GUIDANCE

Private equity has undeniably played a pivotal role in reshaping U.S. corporate governance over the past few decades. The advent of major leveraged buyouts (LBOs) in the 1980s marked the onset of a shift away from unchecked managerialism in the United States. Private equity delivered a clear message to public companies that, even if shareholders were passive, attention

[3] Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds,* 83 N.Y.U. L. REV. 1, 3-5 (2008).

to shareholder value was non-negotiable to avoid the risk of a takeover.[4] "In the middle market, private equity firms targeted private companies lacking financial and managerial expertise", with family-owned businesses standing out as prime candidates for LBOs due to a combination of a solid business model and inefficient operations or capital structures.

In both scenarios—be it the substantial public-company LBOs or the acquisition of smaller private enterprises—private equity ownership had the potential to bring about significant enhancements in the target company. This section outlines the idealized version of private equity, where firms make substantial contributions to improving the governance and operations of their portfolio companies.

In 1989, Professor Michael Jensen foresaw the potential decline of the public corporation, considering private equity as an optimal alternative governance model for firms. This perspective stemmed from a longstanding concern in corporate governance dating back to Berle and Means, who highlighted the issue of the separation of ownership and control in public companies.[5] While tapping into public capital can enhance a firm's scale and reduce its cost of capital, it necessitates the delegation of managerial responsibilities to hired executives since investors themselves cannot directly manage the firm.

The traditional approach of having dispersed public shareholders delegate management introduces a challenge known as the agency costs of management. In this setup, where shareholders lack the incentive or ability to closely monitor management, there is a risk that managers may prioritize personal interests over those of the shareholders. Despite being more efficient than management by dispersed shareholders, this delegation of authority creates a potential misalignment of interests and introduces agency costs within public companies.

Moreover, private equity introduces a mechanism to ensure managerial discipline—the imposition of heavy debt loads on portfolio companies. Unlike public-company managers overseeing cash-rich corporate empires, portfolio company officers face stringent constraints due to looming debt payments. This compels them to manage cash judiciously and operate with maximum efficiency.

However, private equity firms do not pursue good governance for its own sake; the ultimate goal is to translate governance advantages into enhanced firm value, particularly through

[4] Gregg A. Jarrell, James A. Brickley & Jeffry M. Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49, 51-52 (1988)
[5] Adolph A. Berle, JR & Gardiner C. Means, *The Modern Corporation and Private Property* 277-79 (1933).

improved operational efficiency. The forthcoming section explores how intense competition within and outside the private equity industry signals a departure from traditional governance strategies, leading to diminished expectations of the same high returns observed in previous decades. The competitive landscape has significantly narrowed the space for private equity sponsors to effect governance improvements.

III. Rivalry in the LBO arena: outdoing each other in grander ways

Currently, private equity is experiencing what can be described as a golden era, emerging as a well-established asset class that garners significant capital allocations from various institutional investors. Recent fundraising endeavours continue to set records, with sponsors occasionally having to reject investors' funds rather than actively seeking them. While interest rates may be on a gradual upward trajectory due to tightening U.S. monetary policy, they remain historically low, facilitating highly leveraged acquisitions that align with the private equity business model.

However, the heightened competition among private equity sponsors, resulting in lower returns, doesn't necessarily translate into a reduced overall focus on governance. Analogously, lower profits in any competitive market do not necessarily lead to diminished production. A more accurate explanation for the shift away from governance in private equity is the dwindling opportunities for governance improvements. Notably, what has received less attention is the formidable external competition facing private equity from entities outside the industry, including other investment funds and strategic acquirers. This section outlines the key external forces eroding private equity's corporate governance advantage.

For private equity to achieve above-market returns through governance reforms in public companies, a substantial pool of such companies with suboptimal governance must be available as feasible leveraged buyout (LBO) targets. Ideally, buyout funds seek mature public companies with stable cash flows, collateral-friendly assets, management inefficiencies, suboptimal capital structures, operational inefficiencies, and misguided compensation schemes. However, several factors make these conditions less likely to be satisfied than in the early years of private equity.[6]

The disappearance of retail investors directly holding stock in public companies has resulted in predominantly institutional ownership, increasingly concentrated. This shift has dissolved the collective action problems that impeded shareholder monitoring of management in the past.

[6] Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1731-32 (2008).

Activist hedge funds and institutional investors have played a role in shaping public-company governance, making potential targets less attractive or available for private equity acquisitions.

Simultaneously, venture capital funds, traditionally distinct from LBO funds, are now competing for private-company targets, altering the division of labour between the two investment strategies. With founders opting to keep companies private for longer durations and the surplus of private capital, venture capital funds are holding onto successful investments for extended periods, diminishing the pool of companies that would traditionally transition to private equity ownership.[7]

The most formidable competition for private equity comes from strategic acquirers—operating companies seeking potential targets for acquisition. Recent years have seen strategic acquirer M&A transactions outpacing initial public offerings (IPOs). Companies, flush with excess cash, find acquisitions an appealing strategy in an environment marked by technological change, globalization, and relatively weak antitrust enforcement.

In this mature M&A market, private equity no longer holds a distinctive advantage in sourcing deals, optimizing financing and taxation, or leveraging repeated experience with M&A transactions. Consequently, gaining access to the diminishing pool of attractive targets becomes increasingly challenging for LBO funds. The landscape presents a scenario where private equity contends with intense competition from external forces, raising questions about its ability to sustain the historical governance advantage it once wielded.

IV. Complexity and Challenges

Initially, private equity firms were distinctly focused on corporate governance, with the primary goal of selling companies for more than their acquisition cost. The rationale was straightforward: improved governance could directly boost firm value by curbing managerial shirking and indirectly enhance operational efficiency.[8] This approach aligned with private equity's pursuit of superior returns, providing a clear incentive for sponsors' investment professionals.

However, the landscape has evolved, marked by intense competition and a diminishing set of opportunities for governance improvements. Larger private equity firms have diversified their

[7] Andrew Metrick & Ayako Yasuda, *Venture Capital and Other Private Equity: A Survey*, 17 EUR. FIN. MGMT. 619, 619 (2011).
[8] William A. Birdthistle & M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45, 45 (2009).

strategies beyond leveraged buyouts (LBOs) and expanded into other asset classes. Notably, these firms no longer insist on controlling their portfolio investments, opting instead to collaborate with other investors and acquire minority stakes, even in public companies. The shift toward minority investments, coupled with the varying returns they offer relative to buyouts, implies a diminished role for private equity firms in the governance of these minority investments.

Private equity's traditional advantage lay in its unwavering commitment to delivering investor returns. Yet, the current scenario raises questions about which investors private equity sponsors are truly serving. Analogies can be drawn with the experience of investment banks, where boutique advisors gained market share due to concerns about conflicts of interest on Wall Street. Whether major private equity sponsors will face a similar trajectory remains uncertain, leaving us to grapple with the ambiguity surrounding the impact of private equity conflicts on the behaviour and value of their portfolio companies.

The expansion into other asset classes is just one factor contributing to the escalation of conflicts and complexity within the private equity industry. Today's private equity firms are substantially larger organizations, driven not only by diversification but also by regulatory changes and investor demands. The industry's reputation for lean staffing has undergone a transformation, leading to potential misalignment of interests between individual investment principals and the overarching private equity firm. The recent growth in size, particularly for publicly traded private equity firms, introduces challenges in maintaining a reputation for ethical behaviour and avoiding conflicts that could harm investors and counterparts.

A significant challenge lies in the increasing complexity of contracts and arrangements between private equity firms and investors. Conflicts among the sponsors' own funds and adapting to investor demands in a competitive environment contribute to this complexity. Dissatisfaction with the traditional "two and twenty" compensation scheme has led to modifications in arrangements with investors. Instead of universally reducing fund rates, firms negotiate special arrangements, such as side letters and opportunities for co-investment, with investors possessing greater bargaining power.

This growing complexity has implications for the agility of private equity sponsors. Internal organizational intricacies and external contractual commitments make firms less nimble and potentially less focused on the investment side of the business. Side letters, for example, may constrain investment options, leading to uncertainty about whether sponsors' treatment of a given portfolio company aligns with value maximization. In essence, the evolving landscape introduces challenges to the traditional practices and clarity associated with private equity operations.

One common method is obtaining capital call facilities from banks. Instead of calling investor capital when making an investment, the fund may use the capital call facility to borrow funds for the investment, later calling capital from investors to repay the loan. While this strategy enhances the fund's IRR by reducing the period it holds investors' capital, it may not necessarily benefit investors due to the interest payments on the loan.

The Internal Rate of Return (IRR) of a fund gauges the returns on capital invested in various portfolio companies and investments. Significantly, the IRR diminishes as the fund's capital remains invested for an extended period before realizing a payoff. This prompts private equity firms to seek methods to boost their IRR, either through increased returns or by strategically manipulating calculations to expedite returns, thereby minimizing the duration of investors' funds being held.

Given the intensified competition that hinders achieving substantial returns, private equity firms have adopted a strategy to abbreviate the duration of holding investors' funds. A prevalent approach involves accessing capital call facilities from banks. Instead of immediately calling for investor capital when making an investment, the fund utilizes the capital call facility to borrow funds for the investment. Subsequently, it calls for capital from investors to repay the loan. While this approach amplifies the fund's IRR by reducing the period of holding investors' capital, it may not necessarily be advantageous for investors due to the accompanying interest payments on the loan.

Originally intended for short-term use, capital call facilities are now being utilized for more extended periods, allowing funds to fund significant investments without using their investors' capital. This approach, if managed strategically, can result in an artificially inflated IRR for the fund.

Managing IRR is crucial for private equity sponsors for several reasons. First, IRR is the most commonly used measure of a fund's performance, making it a vital component of a private equity firm's marketing efforts. Second, the compensation of private equity sponsors is linked to their funds' IRRs. Profits are typically distributed following a specified priority (the "waterfall"), where limited partners recover their capital and an eight percent preferred return before the private equity manager can claim a share of the profits. Boosting IRR allows the manager to accelerate their participation in the fund's profits.

V. Conclusion

Is the allure of private equity still justified? Recent empirical studies cast doubt on whether private equity's returns continue to stand out among major asset classes. However, it is crucial to also question whether the methods employed by private equity to generate these returns have evolved over time. This article contends that various factors are steering private equity away from its original focus on enhancing firms' governance and operations. Instead, the industry is adopting a diverse range of tactics aimed at maximizing returns. While private equity initially gained renown for its ability to reform and restructure companies, the landscape has shifted, and the industry is now exploring different avenues. It's essential to clarify that private equity isn't fading away; it will maintain its influence and remain a significant magnet for capital in the foreseeable future. However, this influence is likely to manifest in areas beyond corporate governance.

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