The Impact of Private Equity on Public Markets and Valuations

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Corporate Governance refers to the ways in which providers of capital assure themselves of getting a return on their capital.
Who is the firm?

Who gets any residual value?

- Managers
- Employees
- Investors
- Customers
- Suppliers
- Government / Society
Shareholders get the residual.

- Who gets any residual value?
- Allowing the value created by the corporation to be allocated to shareholders changed the world!

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Equity contract encourages risk taking.

...can now be paid in such a way that encourages risk taking.
Risk equals growth and prosperity

- Our capital markets ability to absorb risk is one of the central things that makes this country great.
  - Biotech
  - High tech
  - Software
  - Energy
- The ability of the capital markets to absorb risk goes hand in hand with innovation.
Enforcing the Equity Contract

- Debt is relatively easy to enforce.
  - Increase the penalty for failure to repay!

- Equity is remarkably difficult to enforce.
  - Need verifiable information about **profits**.
  - Need a way to make sure the **decisions** of the management were made for the benefit of shareholders.
Oversight

- A few owners with large stakes have both the ability and the incentive to watch carefully over the firm.

- But concentrated wealth discourages risk taking!
  - Would you really want all of your wealth tied up in a biotech with a speculative cure for cancer?
Stock exchange

- The ability to trade shares allows for diversification.

- Good for shareholders and good for the business.

- Leads to a stock market that is willing to fund enormous risks!
Oversight falters…

- If only 0.01% of your wealth is in a particular stock then do you really have either the information or the inclination to oversee it?

- When oversight falters we get…
  - Bad investments
  - Over investment
  - Over paid CEOs
  - Outright fraud and scandals

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Equity Prices Fall

- If corporations make the wrong choices this is eventually reflected in lower market capitalization.

- Many different studies have shown in different ways that countries with poor governance have lower equity values.
So we need good shareholder rights!

- Right?

- This will NOT do it.
  - Shareholders are diffuse and thus not paying attention.
  - But they control the company!
  - So the company makes easy to explain simple decisions. Things that can be ‘explained’ to the market.
What kinds of things cannot be explained to the market?

Our whole business model is changing and we are not sure we are going to survive!
Private Equity to the rescue!

- Liquid markets make it possible for the ‘watchers’ to stay on the sideline and only move in when needed.

- OVERSIGHT is back even though we have diffuse ownership!
The role of leverage.

- If I can improve a company by 50% then I can just buy it, improve it and resell it.
- But what if I can only improve it by 10% or 5% or 2%??
- Then the only way to make a decent return is through leverage.

- The more open the debt markets the smaller the problem PE can fix.
PE effect on valuation

- At the end of the day PE keeps the value of all firms high.
- First, all firms must run better and return more to shareholders or they get taken over.

MORE IMPORTANTLY PE is a critical part of the corporate governance mechanisms that allow for diffuse ownership which allows corporate risk taking!
Idea in 30 sec…

- Equity encourages risk taking
- Risky firms need diversified shareholders
- Diversified shareholders => diffuse ownership
- Diffuse ownership => Poor oversight
- Poor oversight => bad investments
- Bad investments => low stock value
- Low stock value => PE can make money
- PE ability to make money means they watch.
- Makes the whole thing possible!