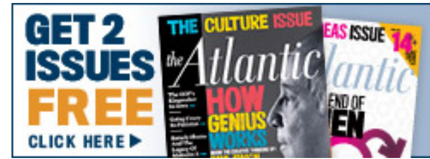
theAtlantic



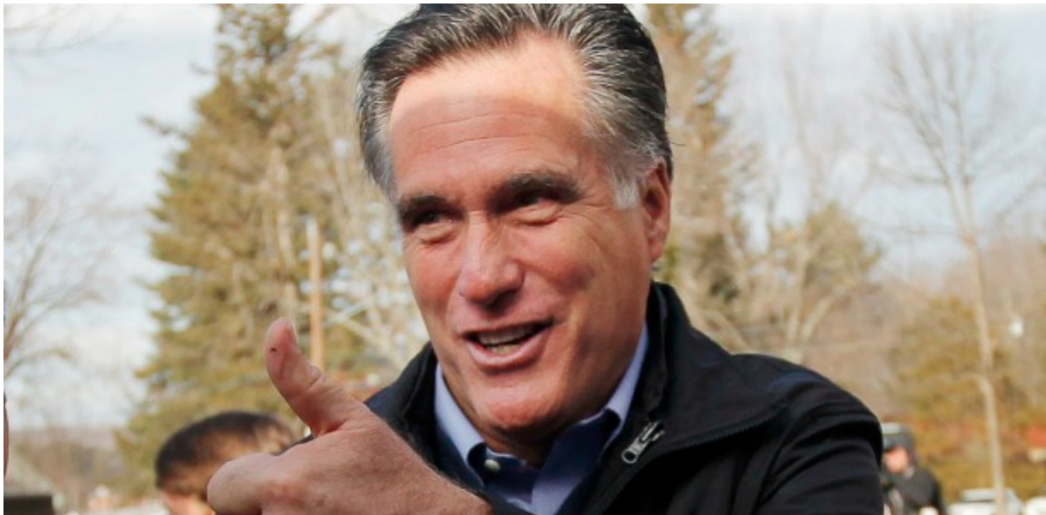
Print | Close

JOIN THE ATLANTIC ON FACEBOOK!

Is Private Equity Bad For the Economy?

By Jordan Weissmann

Mitt Romney's private equity record is suddenly the talk of the GOP presidential contest. What do we know about the industry he helped to create?



Reuters

With Mitt Romney on the march towards the Republican presidential nomination, chances are we're all going to be hearing a lot about the world of private equity for the next 11 months. The GOP frontrunner is already getting tarred by his primary rivals for his time running Bain Capital, where he helped write the playbook on how to buy up companies, rebuild them for maximum value, and flip them for a tidy profit.

Was Romney just running a corporate chop-shop? Or was he pioneering a new way to unlock the value in American business? Whatever the answer, the blueprint he helped design has been massively influential. In 2007, investors had plunked more than $200 billion into funds like Bain.

Academics have scrutinized the broader economic effects of private equity and what it does to companies, industries, workers, and investors. Here's a brief guide to help you answer the question: *Is private equity good or bad for the economy?*

Do private equity buyouts hurt workers?

Yes, then no. More workers get fired in the aftermath. Then more get hired.

In the nightmares of unions and Occupiers, a private equity buyout works something like this: A firm run by men wearing Brioni suits snaps up a helpless corporation, fires as many workers as it can, lards their new asset up with debt, and then sells it off for as much profit as possible. The employees suffer. The fat cats make bank.

The reality, as illustrated in a 2011 study from researchers at the University of Chicago, Harvard, and the U.S. Census Bureau, is more complicated. The paper examined what happened to workers at 3,200 companies targeted in private equity acquisitions between 1980 and 2005. Companies did tend to fire more workers in the years after a buyout compared to competitors in their industry. But they also tended to hire more new workers. They also were more likely to sell off divisions or buy up new ones. As a result, companies involved in a private equity deal saw much, much more turnover -- or "job reallocation" as the academics put it -- but only a net decrease in employment of about 1% compared to other businesses.

In other words, it's creative destruction, but chronologically, it works out more like destructive creation. Employees are fired. Then new ones are hired. The chaos and change is undoubtedly brutal for those who get caught up in it, but the stereotype of massive net job losses isn't necessarily accurate.

Do private equity firms drive companies into bankruptcy?

The data isn't complete, but some indicators say no.

Some criticize private equity firms for leaving companies in worse financial shape than when they were purchased. In its recent look at Romney's record with in 77 companies he worked with at Bain, the Wall Street Journal said that 22% of them filed for bankruptcy reorganization or closed up shop within eight years of the fund's initial investment. However, it's unclear whether those numbers are normal for private equity on the whole.

Steven Kaplan of the University Chicago and Per Stromberg of the Stockholm School of Economics reviewed a sample of more than 17,000 private equity transactions to see how

funds exited the deals. Only about 6% ended in either bankruptcy or reorganization, giving them a yearly default rate that was lower overall than the average corporate bond issuer. That feat was especially impressive, considering that many private equity firms, including Bain, specialize in turning around troubled or risky businesses.

The analysis did not include bankruptcies that occurred after a private equity firm sold off its stake. Does that matter? Depends. You might say a private equity firm can't be held responsible for what happens to a business after they cede control. But these businesses matter to private equity's record if you suspect firms are more likely to offload companies that aren't working out.

Does private equity make the whole economy more efficient?

Possibly. Industries with lots of private equity activity actually see faster growth.

Whether or not private equity helps most businesses, it seems to have a positive effect on the wider business climate. Looking at 20 industries in more than two dozen countries between 1991 and 2007, a research team from the Stockholm School, Harvard, and Columbia University found that industries with private equity activity grew 20% faster than other sectors. After running several mathematical checks, the paper concluded it was unlikely that private equity funds were simply investing in industries that were already primed for faster growth. Rather, they concluded that the lessons from private equity firms taught entire industries to be more efficient.

Do investors make money?

Not as much as you might think. They might be better off putting their money in stocks.

In 2005, The University of Chicago's Kaplan and Antoinette Schoar of MIT looked at whether investors who pour their billions into private equity got their money's worth. The answer: Not so much. Looking at data from 1980 through 2001, the researchers found that, after the managers took out their fees, investors actually made slightly less on private equity deals than they could have by investing in an S&P 500 index fund. Some funds were much more profitable than others. In the big picture, though, stocks won out.

But the fees make all the difference. Private equity firms are known to regularly take a 20% cut of profits. Lo and behold, once the researchers accounted for fees, private equity thoroughly outperformed stocks. Apparently, quite a lot of value winds up with the private equity guys, themselves.

Guys like, well, Mitt Romney.

_

*There was a big gap in the data, however. The research sample marked the outcome of 11% of the private equity deals as "unknown." As Kaplan and Stromberg noted, there might have been more bankruptcies lurking within that group of unknowns. A previous study found that 23% of the large private equity transactions that took public companies private during the 1980s ended in bankruptcy.

This article available online at:

http://www.theatlantic.com/business/archive/2012/01/is-private-equity-bad-for-the-economy/251245/

Copyright © 2012 by The Atlantic Monthly Group. All Rights Reserved.