Going Public or Private ?
The Role of Private Equity Firms

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Private equity firms are thriving and playing greater roles in shaping up corporate market sectors.

DOWNTURN OF PUBLIC LISTING

Listing to stock exchange by becoming a public company has been a regular financial mechanism for a company to generate cash for business expansion. A public company ownership is owned by a collective of group including pension funds, individual investors and mutual funds. The mode of obtaining free interest debt in replacement with dividend sharing and opportunity to raise larger funds in comparison with bank's debts, stimulate many companies to go public. Since then, public equity markets become so actively traded and create impetus for public society to have another alternative for investing their monies. People with mentality of a high level risk resistance are gradually shifting the financial portfolio from "moderate risk and moderate return" to "high risk and high return". Two different needs meet; company expecting inexpensive cost of financial sources and individual investor searching for an alternative to grow financial portfolio more rapidly.

The journey of equity market experiences various degrees of fluctuations, up and down. Emergence of internet era brought about significant positive impact to the market. Both market analysts and investors set high expectations on the new industry to change entire landscape of every business sector. Conventional infrastructures to run a business were greatly changed. Communication, commerce and business process were just a few affected by the internet transformation. However, two sides of a flipped coin seem affected to the new information technology. What once so highly expected to drive investors grasping high investment return had turned around to disaster for some. The bubble exploded. Only a few companies survived, many collapsed leaving to more prudence investment analysis and actions.

Not long afterward, another downturn occurred in early 2000 when a big corporation (i.e. Enron) defaulted and went to financial litigation. A very outstanding firm once known as one of “Big Five” accounting firms plunged in the same hole. Both Enron and Arthur Andersen had lost not only long standing reputation, but also the entity existence. Expecting no other catastrophe, Government of Unites States under an initiative formed in Sarbanes-Oxley Act is enforcing a series of higher scrutiny for publicly listed companies. More information disclosures and underlying activities are becoming mandatory. Time frequencies and effort allocations used for dealing with stakeholders, particularly on fulfilling financial information obligations to SEC, building strong media relationship and providing timely and accurate information to analysts are becoming more intensely than previously. Management of company needs to split focus inside organization and outside taking care of listing administrations.

SARBANES-OXLEY

An increasing inclination for public companies to go private becomes major issue to highlight for these last few years. The Sarbanes-Oxley is the major reason of the tendency. Additional cost to comply with the regulation imposes company to trim down other financial posts. Audit fees increase as company is required to attest the effectiveness of control in protecting financial reporting systems and processes. Cost of productivity lost is another part of the associated costs due to Sarbanes-Oxley requirement. The regulation requires boards of management and company’s external auditors to put each individual confirmation on effectiveness of internal controls over the financial reporting. This escalates liability for the board, particularly CEO and CFO for facing higher risks of shareholder litigation. Both positions are required to sign off on the accuracy of financial reporting, which such actions were not a part of prior regulations. Failure on compliant leads not only to financial penalty, but also does the prison term. In anticipating the risk, some big companies take preventive action by providing liability insurance against the incompliance. Again, another non-small cost which were previously not included in company budgetary is now needs to be allocated.

With more burdens in cash flows and diminishing potential profit, many companies are considering to going private. By going private, companies can significantly reduce the level of risk associated with shareholder litigation, allocating funds to company operation and preserve confidentialities of information materials (e.g. the boards' compensations). For public company, constant quarterly pressures to submit periodical financial reports give another reason to avoid. When share price tumbles, corporate executives have to worry of the possibility getting into shareholder lawsuit. Going private can save accounting and legal fees associated with Securities and Exchange Commission filings. Private company has more ability to run business more effectively by not disclosing strategic moves to competitors and owns more time to do long-range planning. According to a recent survey from Booz Allen Hamilton, 15.3% of CEOs at the world's 2,500 largest public companies left office in 2005, many of them fleeing to private companies that can afford the luxury of a longer-run view. In the downsides, being a private reduces access to funds liquidity and sometimes involves big value of money in process conversion. Company needs to prepare financing to repay the shareholders at a premium share price. The source of financing is likely to obtain from an equity sponsor, like a private equity firm.

ATTRACTIVENESS OF PRIVATE EQUITY FIRMS

Private equity firms is thriving and playing greater roles in shaping up corporate market sectors. On this firm, companies are bought, fixed and sold or taken public. Being a private, a company can avoid public scrutiny, from restructuring organization to cutting costs. A combination of skills is greatly required for people working in the firm. Dealing with investors by taking care monies have been trusted is a part of the job. Placing the right people to manage acquired companies bears certain risks as running regular corporate environments. Raising quantity of private equity firms also leads to attracting potential people to fill in some positions. High profiles executives are getting interested to move up their careers in private equity firms. Holding big reputations they built while with prior companies is a key for persuading entity investors to put more funds in the firm's portfolio. Private equity firms need the profile to back up the acquired companies' operations. They are called for hunting new acquired deals and taking apart in deciding whether to choose existing internal management to run the acquired company or to replace with outsiders. Some take in charge in the company and make turnaround that has become their expertise. Business school graduates are in line too. This breed of mid-career generations shifts the career interest from decade to decade. In 1980s, they wanted to be a part in investment banking. In 1990s, they were obsessed to raise their careers with venture companies. This decade is the turn for private equity firms. The mid-career professionals see the private equity firms as a bridge to run their future own business.

Well-known CEOs, who gained reputation in turning companies around and should have been enjoyed comfortable retirement, are back to corporate practices by clinging to private equity sphere. Mentioning some figures are former IBM chief Louis Gerstner, Millard Drexler seven years CEO of GAP, former General Electric CEO Jack Welch and former Ford Motor CEO Jacques Nasser. Millard Drexler, 61, was hired by Texas Pacific Group in 2003. The group is a $22 billion private-equity firm. A contrast of working environment in such public company as GAP and what Drexler doing within Texas Pacific is greatly different. Public investors are too much obsessed with quarterly earnings, which is not the case for private investors. They care more about long-term shareholder value. Jack Welch joins Clayton, Dubilier & Rice Inc., a $6 billion New York private equity firm. Veteran of IBM Louis Gerstner now takes a seat of chairman at Carlyle Group, a Washington D.C. private equity firm with worth of $35 billion. With about $35 billion under management, the Carlyle Group is one of the private equity industry's largest players. Meanwhile, Jacques Nasser is a partner at the $5 billion One Equity Partners, an affiliate of JP Morgan Chase.

Both established profiles and young breeds are attracted on two things: financial compensation and autonomy. The packages received from the firm are comparable and even higher than public companies. Becoming more interestingly, no more regulations mandating to disclose their total compensation to public in an annual report. Short-term targets translated into quarterly reports are not strongly reflected in the firms. Corporate targets are set with focusing on long-term parameters, giving flexibilities for top personnel to play around with some strategies. Besides assigned to take a lead on the new acquired company, the CEO is also given option to invest a significant portion in the company; publicly-held company does not provide such incentive. After working out for restructurings, the company is ready to sell to public or other party. The more value they can create to the company and take to public market, the more opportunity that CEO owns to double up transaction value. In term of reaching the critical mass and aligning supply chain more effectively, acquired companies under a management of a private equity firm gain advantages compared with other competitors not under management of a private equity firm.

LESS CHECKS AND BALANCES

In Unites States alone, a total of few private equity firms managed a few billion 15 years ago. Today more than 250 firms control $800 billion of capital. The growing of private equity firms is a consequence of market economic. Pension funds, hedge funds and endowments continuously search for more attractive investment offering higher returns. In a number of cases, private equities have proved to provide impressive returns. For a public company that wants to go back privately, it will find a private equity firm with big cash ready to buy outstanding shares with premium prices. Any deals to go private must obtain approvals from both boards of directors and shareholders. Despite increasing growth of exodus from publicly-held companies to become private are in supports from top level executives, some other observers highlight the negative signs. With funding commitments are held by fewer shareholders, check and balances are no longer executable proportionally. The wealth spreading is concentrated to certain group of big investors. Financial information is discreetly closed for internal consumptions only giving little access to outsider observers.

ACQUIRING TARGETS

Big names of private equity firms such as Carlyle and Blackstone Group are competing to offer best deal to a selected number of quality targets. The targets usually attracted to the deal rather than staying in the public market as equity funds are offering a premium for the company that was undervalued. When the target is quite big to handle by a single firm, some private equity firms join forces to take over the target. Fees earned by the firms are a part of the reason attractiveness of this sector. The firms can gain significant fees from the buyout transactions. In addition to the 2% management fees that the firms regularly collect from investors, each buyout transaction gives additional cash to the pocket of private equity firms. It includes 1% deal completion fee, arranging financing fee, due-diligence and monitoring fees. Big firms usually hunt for transactions with value more than $1 billion. With such high fees attracts more business people to get into the business. Financing of the transactions also involves leverages from banks in some percentages. A solid connection is built by bank to private equity firms by lending funds to complete the buyout transactions. The firms have becomes special clients and contributing to major portions of bank income. As the buyout increases, debt levels also increases. This makes banking sectors as a creditor need to secure the given funding. Amid the growing competition, a few investment arms of large financial institutions refocus their equity funding. Citigroup just recently released its buyout unit, Citigroup Venture Capital. The newly formed company is no longer managed by Citigroup and become a private equity firm with a new name of Court Square Capital.

Aramark, a public company based in Philadelphia, was in a bid by a collective of private equity investors with a transaction value of $6.3 billion. GS Capital Partners, Thomas H. Lee Partners, Warburg Pincus, CCMP Capital Advisors, and JPMorgan Partners officially made the bid on August this year. When successfully executed, this is the second time for Aramark to go private after trading its shares to public. As founded in 1936 by selling peanut, Aramark now runs the chains of food and facilities-management services to business, education, health care, government, and sports and employs 14,000 workforces.

Retail sectors are the serious target for Private equity firms. Neiman Marcus, a large home furnishing retailer, was agreed in 2005 to be acquired by a joint of private equity firms namely Texas Pacific Group and Warburg Pincus for about $5.1 billion. The reason of increasing interest over retail is that the stability shown by the industry. With low number of bankruptcies and liquidations, retail industry becomes less risky to invest. In 2005, about a quarter of retailer acquisitions were carried out by private equity firm rather than corporate buyers. Other transactions for buying in retailers involved Blackstone Group and Bain Capital in acquiring Michaels, a craft-store chain for $6 billion. The two partners had defeated another offer submitted by Kohlberg Kravis Roberts and Texas Pacific Group.

ACCOUNTING AND TAX STRUCTURING

The US GAAP requires buyout transactions are stated at fair value. Over time, private equity firms use quoted prices in active markets as the estimated fair value. To be in line with guidelines set by US GAAP, industry groups including the Private Equity Industry Guidelines Group in the United States and the venture capital associations in Europe devise a set of guidelines to estimate the fair value. Process of determining fair value may subjects to various interpretations. However, using common views of GAAP and supporting guidelines can narrow the gaps on interpretations. Other than the quotes price in active market to use for giving approximation of fair value, similar industry transactions may also be used.

An entirely successful buyout transaction by private equity firm should not miss on effective tax structuring. It is in a way of how to reduce any potential cost of tax and ensuring there is no tax leakage. A few important aspects to look at are the acquisition cost and the repayment of shareholders loan. The loan to shareholders is managed as possible without incurring any income taxes or withholding taxes. To keep minimized of the withholding tax, the firm can include at least one holding company in the structure. Most regulations accept holding companies as an inclusion. As many transactions still heavily rely on debt financing, entire interest costs need to be paid on pre-tax basis. This is executable by setting up local acquisition vehicles to acquire the particular local company generating the profits and allocate a portion of the cost of financing to this newly formed group. In financing the transaction, an alternative can be used in financing through shareholder loans. Benefit on using shareholder loans as a means of financing as opposed to ordinary equity is that it creates tax-deductible expenses in the form of interest in the group acquired where dividends are not deductible. The drawback for some investors is that interest accruing is considered a taxable income in the investors that can potentially cause tax costs although no payments have been made.

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