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November 27, 2006

## COMMENTARY

# What's So Great About Private Equity

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November 27, 2006; Page A13


What's so good about private equity? A lot. That's why private equity has emerged as a large, successful and growing asset class that attracted more than \$300 billion in new investor commitments this year and that is responsible for more than 20% of total merger and acquisition activity in the U.S. and Europe in 2006. Put another way, as a chief executive once chided me, "Why can't a public company management team do every damn thing that you guys do when the company is private?"

Unfortunately, there are many reasons that public companies can't "just do it." Many public CEOs tell me that they feel like Gulliver bound by a thousand ropes: It is extremely difficult for public company CEOs and their management teams to focus and execute long-term strategies that require fundamental changes in business practices at the same time as they are responding to the cacophony of their many, multiple constituencies. In an economic environment riddled with land mines, then, private equity has several compelling structural advantages.

**Better governance.** This is a bold statement, but I believe private-equity firms today have a better governance model than public corporations. The "agency problem" fades away because the owners are a team of focused professionals who directly control (but do not manage) the business. Private-equity firms recruit industry and functional experts as directors who want tangible engagement with the business rather than a social forum; start off with a well-defined set of objectives to change business performance; insist on tight reporting requirements; and run board meetings that are issue-oriented, not show-and-tell.

**A more stable shareholder base.** The largely institutional investors that comprise most of the private-equity limited partner base define themselves as long-term investors. State and corporate pension funds and endowments for universities and charitable foundations have very long-term missions -- think 50 years or more -- and look to private equity to provide returns that are superior to the public markets. At least for these investors, who can select private-equity firms that routinely deliver top quartile performance, returns have not disappointed. Although recent internal rates of return have been exceptionally high due to faster-than-usual realizations, the long-term top performers in private equity have been able to outperform the major indices by well over 500 basis points. Accordingly, many sophisticated institutions have increased their allocations to "alternatives" to 15% to 20% and have reduced their traditional allocations to public equities and bonds by the same amount or more. Compound that out-performance over many years and the results are startling.

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***Opportunity to upgrade management talent.*** Private-equity firms recognize that people make all the difference and so have a relentless focus on drafting the very best talent. Private-equity firms today are a magnet for talent, and they typically seek to add several new managers in "skill positions" that really matter. Depending on the company, that could mean one or more new executives to head sales or marketing, finance or, sometimes, the entire business. I speak with two or three great managers a week, each seeking a position in a private equity-sponsored company. They are uniformly competitive, winning executives who are anxious to get back to what they love to do -- build businesses. Today more than ever, it is easy for private-equity firms to attract world-class managers, offering both management freedom and innovative, stock-based compensation plans. More job satisfaction and more money are hard to beat.

***Resetting Expectations.*** A change in ownership offers a great opportunity to reconsider assumptions about how a company gains and sustains its competitive advantage. A fresh look at the business, unencumbered by legacy strategies and investments, is usually the starting point for good private-equity investors, and often leads to reallocation of capital, new research and product priorities, emphasis on different market segments and sharper understanding of a company's competitive cost position.

When a buyout occurs, it is a big event, and everyone from the CEO to first line supervisors in the field to vendors and customers expects change and a higher bar for performance. As the industrial sociologists have known for years, this period of heightened expectations creates a wonderful climate for innovation. The first year of a buyout is an unparalleled chance for the management team, backed by the new owners, to demonstrate that things will change.

***More efficient capital structures.*** Private-equity firms are comfortable using significant -- but safe -- levels of debt to finance a significant portion of their investments. As a period of unequalled liquidity has swept the world capital markets in the past few years, private-equity firms have capitalized on low interest rates and relatively loose covenants to shape capital structures that improve likely returns on equity. Public companies could do the same -- but are reluctant to do so, clinging to more conservative goals of maintaining historical debt ratings.

***A sense of urgency.*** Private equity owners bring a sense of urgency to the entire business. This reflects a realization that global forces erode a company's competitive position every day that the management does not act to deliver more value to its customers. Speed of execution itself becomes a competitive advantage that is squandered by companies that manage by committee and fail to seize opportunities.

These are powerful advantages that are only compounded by the ways that professionals in private-equity firms have learned to deploy capital. Supremely opportunistic, they recognize that the flexible and transitional nature of their capital means that they can fill spots in the global restructuring environment that public company capital cannot. They have established a highly effective form of financing and governance that enables large struggling corporations to remain competitive in response to the rapid changes in the global economy. They "just do it." Many public companies struggle to keep up.

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<http://online.wsj.com/article/SB116459816859233270.html>

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