Testimony of Douglas Lowenstein
President, the Private Equity Council
Before the House Financial Services Committee
Washington, DC
Wednesday, May 16, 2007

Mr. Chairman and members of the committee: Good morning. My name is Douglas Lowenstein and I am president of the Private Equity Council, a new organization that represents ten of the leading private equity investment firms in the United States.[1]

Thank you for providing us the opportunity to be part of this Committee's effort to better understand the role of the private equity industry in the U.S. economy. This hearing marks the Private Equity Council's first presentation to a congressional committee, and we hope it represents the start of a continuing dialogue on issues of mutual interest.

Before addressing the issues the Committee has raised, I think it would be helpful to take a moment to demystify private equity. While some have a perception that private equity is a form of black box finance practiced by a small cadre of New York investors, the truth is that private equity is about hundreds of thriving companies contributing to the economy in numerous positive ways. When you buy coffee in the morning at Dunkin' Donuts, you're interacting with private equity; when you see a movie produced by MGM Studios and buy your kids ice cream at Baskin-Robbins afterwards, you're interacting with private equity. When you shop at Toys R Us for the hottest new video game or the latest "must have" doll, or when you buy a new outfit at J. Crew, you're touching private equity. When you buy pet food and supplies for your dog or cat at Petco, that's private equity, too.

Private equity is not just about household brand names. When you make online plane and hotel reservations for your vacation, you may be relying on private equity. Many of us work in office buildings owned by private equity firms, and drive cars and fly in airplanes that rely on parts and equipment made

[1] Apollo Advisors, Bain Capital, The Blackstone Group, The Carlyle Group, Kohlberg, Kravis & Roberts, Hellman & Friedman, T. H. Lee Company, Providence Equity, Silver Lake Partners, and TPG Capital.

by private equity-owned firms; even the power that lights our homes in some parts of the country is delivered by private equity companies.

Further, private equity investments directly and indirectly benefit tens of millions of Americans. Public and private pension funds, foundations and university endowments have chalked up returns from private equity investments that far exceed those available from the stock market. Between 1991 and 2006, private equity firms worldwide created more than $430 billion in net value for these and other investors. These returns translate into stronger public employee pension programs, more funds for college financial aid and scholarships, and more funds for research and other causes supported by charitable foundations.

Private equity is intrinsic to American capitalism. Venture capital, for example, is a form of private equity used at the start-up phase of a business. By contrast, the transactions under review by this Committee are more typical for companies in later stages of their development. These transactions may take many forms. They may involve the acquisition of a private company with the intent of providing its founders the capital necessary to take its performance to the next level. They may involve the acquisition of a division of a large company, with the purpose of offering the newly independent business the management focus and resources needed to achieve a new mission. They may involve "privatizing" a public company in an effort to undertake improvements that would be difficult to achieve with the short-term earning focus of the public markets.

Academics and business leaders have recognized for years that the public markets sometimes distort the incentives for companies to put in place sound long-term business strategies. Because the managers of publicly-owned companies are forced to keep a close eye on quarterly earnings to maintain their stock price, they sometimes are hesitant to make the often substantial investments in new processes, personnel or equipment required to drive strong, long-term growth, but that can depress earnings and lower share prices in the short term.

Private equity firms, on the other hand, can take a longer view. Without the pressures from outside public shareholders looking for short-term gains, owners and managers can focus in a laser-like way on what is required to improve the medium to long-term performance of the company. This structure also

makes it far easier to align the interests of owners with those of managers who also have a direct stake in the success of the company.

Ultimately, the mangers of private equity firms understand that they must improve the underlying value of the companies they own over time to continue to attract the capital they need. By better aligning owner-manager interests and by instituting a nimbler operating style that fosters greater innovation and long-term investment, private equity owners are leaders in spurring improved productivity and competitiveness.

Private equity is not a silver bullet, nor is it the right solution for every company. In the end, it is nothing more than a flexible form of ownership that, in appropriate circumstances, can create a successful operating environment for companies at different stages and in different conditions.

The Committee has asked that we address three issues: first, whether firms acquired through private equity make the investments in technology, capital equipment, and research essential to long run productivity growth; second, do workers find themselves disadvantaged through financial or other restructuring, and third, what are implications of private equity profits for growing income inequality in this country.

Private Equity and Growth

It is important to understand one central fact about private equity: private equity firms seek to improve the performance and increase the value of the companies in which they invest. Any other approach would defy common sense, because the entire business model rests on selling investments at a gain. That's why those who claim that private equity is all about asset stripping are missing the point: it is rather difficult to strengthen an underperforming business if you first vaporize the assets and the workforce. Bear in mind that after a private equity fund returns a company to public ownership, it usually maintains a very substantial equity stake in the company. In other words, if it adopts a short-term mentality, it takes money out of its own pocket by undermining the value of its own long term investment.

There has been much discussion about the degree to which private equity firms use debt as a tool in their transactions, and this is the premise for the Committee's question about private equity's

commitment to long-term growth. In today's intensely competitive environment, the use of efficient capital structures remains important. Adding debt does promote fiscal discipline, discouraging wasteful spending on things like "country club" corporate headquarters. However, a strategy of simply adding more debt to an "underleveraged" balance sheet – which once might have sufficed to allow private equity firms to recognize substantial gains with only modest performance improvements – no longer works.

In the leveraged buyout wave of the 1980s, financing was often 90 percent or more debt and 10 percent or less equity. Since 2002, PE deals average in the range of 60 to 66 percent debt, though there have been more recent deals with higher debt levels due to the unusually low interest rate environment we've enjoyed the past few years.

In any event, regardless of the debt levels, to succeed today, a private equity firm needs to bring much more to the table than financial creativity. The PE firm must add new capabilities to the company it buys (by adding new products), increase competitiveness (by reducing waste and improving operations) and grow revenues (by entering new markets or finding new customers) in order to make any money for itself or its investors. And it needs to develop, implement and successfully execute a compelling strategy to do so. The best private equity firms today must bring to the table much more than capital. They deliver deep expertise in the sector in which the investment is being made; managerial and functional (IT, for example) capabilities; a performance culture that rewards entrepreneurship and results; and an ownership structure that allows even the toughest decisions to be made quickly.

A recent analysis by McKinsey & Company of more than 220 transactions using primary data collected from firms in the U.S. and Europe that were held by PE firms for three and one-half years or more showed that PE fund performance is disproportionately driven by the very best and the very worst transactions in each fund. And for these outlier transactions, company performance is the main factor driving returns. In the very best transactions (with annualized returns of more than 60 percent), 70 percent of the value created came from improving company performance. In those that did not produce significant returns, the failure was caused by the general partner's inability to make fundamental improvements to the company's operations.

Consider the private equity acquisition of SunGard, a major software developer and vendor which was under tremendous pressure from public shareholders to increase its earnings. SunGuard CEO Cristobal Conde has said that under private equity ownership, the company plans to complete 53 new research projects in 2007, up from about 10 annually pre-PE acquisition. Under the new ownership, SunGuard's common services architecture program is thriving, covering 60 SunGard products, compared to four before the private equity acquisition. The firm is annually training about 800 programmers, up from 50 prior to the transaction, as part of a focused effort to streamline software development and distribution and reduce the cost of rolling out products and make it easier to integrate SunGard software with other vendors' products.

Or take The Carlyle Group's 2005 acquisition of a company called AxleTech International Holdings, Inc., which designs and manufactures drive train components for growing markets in the military, construction, material handling, agriculture and other commercial sectors. AxleTech was a solid business, but it was focused on the low-margin, low -growth commercial segment of the market. Under Carlyle's strategic direction, AxleTech undertook a concerted business development initiative to offer its axle and suspension solutions to military vehicle manufacturers in need of heavier drive train equipment to support the heavy armored vehicles required to protect American soldiers in Iraq and Afghanistan. At the same time, AxleTech expanded its product and service offerings in its high-margin replacement parts business while continuing to grow its traditional commercial business. Since Carlyle's acquisition, AxleTech sales have increased 16 percent annually and employment has increased by 37 percent, from 425 to 568. New jobs were created in AxleTech's facilities in Troy, MI, Oshkosh, WI, and overseas. AxleTech is one of the very few U.S. automotive-related companies that are growing in today's challenging industry environment. AxleTech's job growth does not take into account the ripple effects on AxelTech's suppliers who are experiencing new hiring and capital investments.

Finally, KKR's acquisition of ITC Holdings, an electric power transmission company in Michigan, offers a third case study of how private equity firms invest in the long-term health of their companies. When KKR acquired the company, it had a capital budget of $10 million and 28 direct employees; since being acquired, ITC has invested $400 million to rebuild and upgrade the transmission grid in its service area of southeast Michigan. ITC's annual capital budget is now $200 million, and employment has grown to 230

direct employees. In January, 2007 Michigan Governor Jennifer Granholm commended ITC for its "commitment to enhancing electric reliability" and for "investing in our electric transmission infrastructure to ensure that electricity will be delivered to millions of Michigan citizens as well as customers in other Midwest states."

Private equity is not perfect, nor does it always deliver the results predicted for its portfolio companies. Sometimes, firms do add too much leverage; sometimes, management cannot deliver successful growth strategies. But there are literally hundreds of positive stories similar to the ones I have described here. And overall, in the most thorough research on the impact of private equity to date, a study by the British Venture Capital Association found that PE companies in the UK grew sales faster than public firms and that their investment and R&D outlays grew at an average annual rate of 21 percent, results I expect are replicated here in the U.S.

Perhaps the best indicator that private equity firms build stronger businesses is revealed in research by Harvard Business School's Josh Lerner. In a recent study, Lerner found that the stock prices of companies operated by private equity firms for more than a year outperform the stock prices of industry peers that remained in public ownership. In other words, if we believe that the public markets reward the best-run companies, the Lerner study offers undisputed evidence that private equity creates significant value in the companies they owned.

Private Equity and Workers

The second question raised in the Committee notice regards the impact of private equity on working men and women. While data on private equity investment's impact on employment in the U.S. is anecdotal, a void the PEC hopes to fill in time, research in Europe suggests that PE investments do indeed result in long term job growth. A study by the international management consulting firm A.T. Kearney found earlier this year that PE firms generate employment, on average, at a much faster pace than comparable, traditionally-financed firms. Research by the BVCA on both venture and private equity portfolio companies found that during the last five years, businesses backed by private equity increased employment an average of nine percent per year compared to one to two percent for public companies. Earlier this year, the Financial Times studied the 30 largest European private equity transactions in 2003-04 and reported that "overall, jobs were more likely to have been gained than lost

as a result of private equity- backed buys." I cannot say definitively that the same outcomes occur in the U.S., but there is little reason to think differently.

That said, the recent increase in private equity activity is part of a larger and pervasive domestic and international economic wave that is driving changes across all classes of American companies, regardless of their capital and ownership structure. Profound forces unrelated to private equity are reshaping the American economy. In his work on the New Democratic Network's Globalization Initiative, economist Rob Shapiro has noted that while we have been in a period of sustained economic growth since the 2001 recession, as measured by GDP and productivity rates, wages for American workers have been flat or declining when adjusted for inflation. At the same time, job creation is occurring at a lower rate than after prior recessions.

I am not here to analyze the reasons for these unusual trends, nor am I qualified to do so. I raise it because it is important to understand the larger context in which private equity operates, and not to view it in a vacuum as if it can be isolated from these larger forces. Private equity is not causing these economic changes; but neither can it operate in a business environment isolated from them. The simple truth is that, as with any other acquisition involving public or private companies, private equity transactions can result in layoffs. In other cases, they may be short term layoffs until job growth over the long term increases as the business grows stronger. In still other cases, they may involve immediate employment growth. Even when some layoffs are essential, private equity has probably preserved hundreds or thousands of jobs that might have otherwise been lost by underperforming or failing businesses. In the end, this much I know: there is no evidence that private equity firms are more likely to cut jobs than any other form of ownership.

In fact, in the last months, we have read about a stream of layoffs at companies not involved in private equity acquisitions of any kind: Ford Motor Company, Circuit City and Citicorp, to name a few. Of course, if you're a worker, a lost job is no less painful regardless of the cause. And the point I am making is that demonizing private equity as a uniquely causative factor for job losses in this country is not just inaccurate, it diverts us from developing a more comprehensive national economic policy to deal with the evolving world in which we live. And as I said earlier, the entire business model of private equity is predicated on increasing value, not destroying it.

Private Equity and Income Disparity

The final area of interest to the committee is the impact of private equity on income inequality in this country. Undeniably, there are those in private equity who are doing very well. Fundamentally, this reflects the fact that they are good at what they do and that they have built significant value in their own businesses and in the companies that they acquire. Their personal success is directly tied to whether they in fact acquire companies, grow them, increase their value, and sell them for a gain. If they fail to do so, their access to investors' capital would dry up and they would be out of business. Moreover, there is no guarantee they will succeed, and the landscape is littered with private equity firms that crashed and burned precisely because there are real risks in PE investing. Not everyone does it well.

Equally undeniable is the fact that we have an income inequality issue in this country. But I submit to this Committee that the forces contributing to this go far beyond private equity, as do the solutions. Private equity is not the reason American companies are being pressured to lower costs, restructure, and employ new strategies to better compete with China, India and other emerging economies. And private equity alone cannot confront the forces contributing to the growing income disparity. But the members of the Private Equity Council are prepared to be part of a national dialogue about how to reverse this trend.

At the same time, it is important to point out how private equity is benefitting Americans from all walks of life. While the impact of PE on jobs is one important measure of its worth, it is not the only measure of private equity's impact on both workers and other Americans inside and outside the companies acquired. The beneficiaries of private equity include tens of millions of Americans whose retirements are made more secure by the very strong returns earned by public, private and union pension funds that invest in private equity ventures; they include the thousands of young people who obtain financial aid or scholarships to public and private colleges because of the high returns earned by university endowments investing in private equity; and they include those of us who may one day benefit from research to cure or treat a disease funded by a foundation generating above-average returns from private equity.

In fact, public pension funds, university endowments, and leading foundations accounted for one-third of all capital allocated to private equity in 2006. The 20 largest public pension funds for which data is available[2] - including the California Public Employees Retirement System, the California State Teachers Retirement System, the New York State Common Retirement Fund, and the Florida State Board of Administration - currently have some $111 billion invested in private equity on behalf of 10.5 million beneficiaries.

These investors seek out private equity because the return on investments made in private equity funds far outstrips that delivered by many other investment opportunities, including the public markets. Between 1980 and 2005, top-quartile private equity firms, on average, delivered to pension funds and other limited partners annualized net returns of 39 percent. During the same period, the S&P 500 posted returns of 12.3 percent. In the past five years, returns on investments made in companies by top quartile private equity firms averaged 20 percent, compared to seven percent for the S&P 500.

Let me give you a concrete example of what these numbers mean to real people. The Washington State Investment Board, which is responsible for more than $75 billion in assets in 16 separate retirement funds that benefit more than 440,000 public employees, teachers, school employees, law enforcement officers, firefighters and judges, has been a major private equity investor for 25 years. In that time, the WSIB has realized profits on its private equity investments of $9.71 billion. Annual returns on private equity investments made by the board since 1981 have averaged 15 percent, compared to 10.1 percent for the S&P 500. Put another way, the excess returns generated by private equity investments during that period are worth $26,000 per retiree; or expressed another way: these returns have fully funded retirement plans for 10,000 WSIB retirees.

---

[2] California Public Employees Retirement System, the California State Teachers Retirement System, New York State Common Retirement Fund, Florida State Board of Administration, New York City Retirement System, Teacher Retirement System of Texas, New York City Teachers Retirement System, New York State Teachers Retirement System, State of Wisconsin Investment Board, New Jersey State Investment Council, Washington State Investment Board, Regents of the University of California, , Ohio Public Employees Retirement System, Oregon State Treasury, State Teachers Retirement System of Ohio, Oregon Public Employees Retirement Fund, Pennsylvania Public School Employees Retirement System, Michigan Department of Treasury, Virginia Retirement System, Minnesota State Board of Investment.

Overall, between 2000 and 2006, private equity firms distributed $181 billion in profits to their limited partners in the U.S. alone. A corollary benefit from these exceptional returns is that dozens of states have been able to avoid budget cuts or tax increases that would have been required to meet their legally-mandated pension obligations to retirees who have devoted their careers to public service.

The bottom line:

Private equity makes significant contributions to the American economy. Through superior investment returns, it delivers important financial support for universities, research institutions and pension funds that benefit tens of millions of Americans. With infusions of capital, talent and strategy, private equity firms improve the productivity, performance and financial strength of the companies in which they invest. Private equity is not a silver bullet, neither is it a dark force. It is an innovative, flexible financial tool that has proven very successful in responding to the global challenges faced by American businesses today.