

Billionaires for Obama

Can private equity funds survive a hostile political environment unscathed? BY IRWIN M. STELZER

There are times when profound changes to our economic system proceed without notice. This might be one of those times. Capitalism is once again doing what it does best—adapting to change. That’s what the wheeling and dealing of those billionaire private equity funds is all about. But the emergence of a class of *nouveaux très riches* entrepreneurs, with lifestyles that make investment bankers look underprivileged, has Congress considering new tax rules to stem the tide of private equity deals by raising the tax on profits earned by private equity entrepreneurs from the 15 percent long-term capital gains rate to the ordinary income tax rate of about 35 percent.

As Andrew Roberts points out in his masterful *History of the English-Speaking Peoples Since 1900*, the development of the limited liability company—the modern corporation—“opened up the modern capitalist system that has brought prosperity to every society that has ever properly adopted it.” That system has gone through many phases. During the 19th century, huge corporations, many having acquired monopoly power using methods that could not long pass muster with the public, made their appearance. The result was a reaction that produced the anti-trust laws, stripping what Theodore Roosevelt called “malefactors of great wealth” of that power and establishing the rules that linked competition to capitalism, creating the socially

mobile meritocracy for which America is admired and envied abroad.

In the 20th century these companies grew by raising huge sums in small amounts from widely dispersed shareholders. This allowed corporations to garner economies of scale, but it also created a managerial class independent of the scattered shareholder-owners of the business. As Adolf Berle and Gardiner Means pointed out in 1932 in their classic, *The Modern Corporation and Private Property*, “The separation of ownership from control produces a condition where the interests of owner and of ultimate manager, may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear.”

Unlimited and unaccountable power inevitably produced abuses: executive salaries that bore no relation to performance; mergers that aimed more to aggrandize the executives of the acquiring company than to obtain efficiencies; more attention to executive perks (golf-club memberships, luxurious corporate apartments) than to enhancing shareholder value.

Enter Michael Milken and his corporate raiders, sharks, predators, greenmailers—pick the pejorative of your choice. In the 1980s, Milken created the “junk bond,” a perfectly sensible debt instrument that allowed entrepreneurs who did not share a country club membership with their bankers to borrow money to finance the takeover of badly managed companies. These takeover artists ended up both owning and managing the companies they acquired. Faced with the burden of servicing the enormous debt they had incurred, they grounded

corporate jets and sold off company wine cellars in order to increase profits and the value of their holdings.

Once again there was a reaction: Highly leveraged balance sheets fell from favor. Corporate managers regained control of their companies, relying, as in the past, on the dispersion of ownership to engage in practices that at minimum did not enhance shareholder value, and at worst landed those executives in jail.

Enter private equity (PE), described by its trade association, the Private Equity Council, as “partnerships formed to acquire large (often controlling) stakes in growing, undervalued or underperforming businesses.” Somewhere between 90 percent and 97 percent of the money in these partnerships comes from pension funds, endowments, and individual investors; the balance comes from the entrepreneur known as the general partner.

In addition to the stake that his investment buys, the general partner typically receives another 20 percent of the profits in the deals he engineers to compensate him for his time, knowledge, and talent. When the performance of the acquired company is sufficiently improved and its value enhanced, it is returned to the public market—rather like a tired and obese athlete returning to competition after a stay at a rehabilitation spa.

Just as talented trainers can improve an athlete’s performance, so the management talent that is flocking to the private equity firms in response to potentially rich rewards, can tone up flaccid businesses. Douglas Lowenstein, president of the Private Equity Council, last week told the House Financial Services Committee that data from Europe demonstrate that private equity firms grow both sales and employment faster than firms whose shares are publicly traded. Of course, there are also failures, in which case the private equity entrepreneurs and their investors take losses, and the entrepreneurs have some serious explaining to do to potential investors when they try to raise money for their next fund.

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The reach of these firms makes the improvement in performance of the companies they own and manage of significance to the overall economy. KKR, led by Henry Kravis, a big hitter for more than three decades and the man who engineered the \$30 billion buyout of RJR Nabisco in 1989, participated in deals worth \$120 billion in the first four months of the year, and now controls companies with 565,000 employees and \$107 billion in annual revenues. Its rival, Blackstone, led by Steve Schwarzman (he of the \$5-\$15 million, depending which tabloid you read, 60th birthday party), controls companies with 400,000 employees and \$87 billion in revenues.

No one loves a revolutionary, especially one who manages to unnerve the entire industrial/financial establishment. Theodore Roosevelt was hated by entrenched business interests for passing the antitrust laws. Mike Milken was hated by the corporats of his time for making it possible for social outsiders, many of them "young, aggressive, and Jewish," according to one description, and therefore ineligible for membership in the better clubs, to take over old-line sleepy companies. Thanks to Milken, the "barbarians" were able to batter down the gates.

The new private equity crowd, in its turn, is facing hostility from three sources. The first is the corporate "establishment," with its usual hostility to the entrepreneurs who are the agents of the "perennial gale of creative destruction" that Joseph Schumpeter claims is "the essential fact about capitalism." For the entrepreneur, adds Schumpeter, "his characteristic task consists precisely in breaking up old, and creating new tradition," motivated by "the will to conquer." That produces what Tom Wolfe calls "the collision of new money and old money or, to be more accurate in the American context, slightly older money."

The second group that feels threatened by private equity is the trade unions, which worry that PE takeovers will mean massive job cuts.

Never mind that most studies show that companies acquired by private equity funds grow faster and create more jobs than their publicly traded counterparts.

Finally, we have politicians, always threatened by forces they do not understand, and always worried about developments that increase inequality of income distribution. In the case of the Democrats who now control Congress, obligations to their trade-union supporters, and a strain of that disease, egalitarian redistributionitis, make them suspicious of organizations that spawn billionaires. But because

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these billionaires are big funders of Democratic candidates, Congress has decided to postpone consideration of any tax changes that would disadvantage these new wealthy potential contributors.

That might change. Most of the PE crowd is supporting Barack Obama in his fight to wrest the Democrats' presidential nomination from Hillary Clinton. These donors are loaded with "the freshly minted money spawned by the hedge-fund and private-equity eruptions of the new millennium," is the way *New York* magazine put it. Should Senator Clinton make it back to the White House, these "freshly minted" bil-

lionaires might find the tax code changing in ways so unpleasant that they would have to say goodbye to Greenwich, Connecticut, and hello to some Caribbean island, London, or another of the offshore locations now being studied by their lawyers. "There will be total retribution if the opportunity presents itself," one Clinton staffer told *New York*.

But the political turmoil created by private equity funds is far less relevant than the economic upheaval. We might, just might, be entering a new phase of capitalism. Firms taken over by private equity funds will have to improve their performance; publicly owned firms competing with them will have to respond by improving their own profitability. Life at the top of corporate America will be less pleasant. Which is what dynamic capitalism is all about—change that discomfits the comfortable.

The anti-private equity crowd, those who fear that these new centers of economic and political power will curtail their own, might take heart from two bits of news. Blackstone, after trumpeting the virtues of private as opposed to public ownership, has decided to go public to raise up to \$4 billion. And several of the companies acquired by these funds, after having been made leaner and meaner, are being returned to public ownership. Dealogic, a firm that keeps tabs on these things, reports that of the 69 companies that have gone public this year, 23 were sponsored by private equity firms. They might also find solace in the fact that no tree grows to the sky: If interest rates do as Alan Greenspan expects them to do, and rise, the cost of funding these ventures, which rely on debt for about 60 percent of their capital, will rise, and the role of private equity might well diminish.

So what goes around, comes around, as capitalism proves again its ability continuously to reinvent itself, this time by providing an incentive for private equity funds to snap up companies, do what is necessary to make them efficient engines of progress, and return them to public markets. ♦