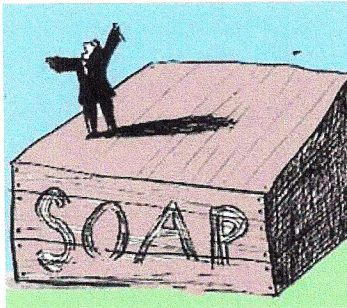


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Why private equity has a tough time finding love

Posted by Dan Primack
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Private equity just wants to be appreciated. A first step would be to admit that it isn't always acting in its portfolio companies' best interests.

During a recent Columbia Business School conference, several private equity execs talked about what a lousy job their industry does on public relations. Specifically, they bemoaned how John Q. Public still sees them as strippers and flippers, rather than value-added investors who often leave companies better than they found them.

It certainly is true that private equity firms can help grow companies and make them more efficient. For example, yesterday we noted that billing system changes were among the reasons that revenue at HCA Inc. had risen 25% since the hospital chain was taken private in late 2006.

Unfortunately, it also is true that private equity firms often undercut their own argument by executing dividend recapitalizations. At best, such transactions force PE-backed portfolio companies to pay a higher yield on their debt. At worst -- and more commonly -- they force companies to take on additional debt. In both cases, the only beneficiaries are private equity owners, who get to reduce their investment risk by taking money off the table up-front.

Go back to the HCA example. Its private equity owners put around \$5.3 billion of equity into the \$33 billion deal -- the rest was leveraged financing and the assumption of existing HCA debt -- and last year recouped \$4.35 billion via three dividend recaps. Assuming the IPO prices tonight, those firms will be in the black with billions of dollars worth of HCA shares remaining in their portfolios.

Such a strategy is completely kosher. Private equity owners have every right to restructure balance sheets in order to line their pockets. Again, they are *owners*.

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But private equity owners should not simultaneously argue that they do everything in their power to improve a company. Adding debt for the purpose of a dividend recap is a value extraction process.

HCA has a lower debt-to-EBITDA ratio today (5.24x) than it had prior to its acquisition (6.5x), but it would be even lower were it not for the dividend recaps. In other words, the company would have more value.

Private equity should readily admit this reality, rather than trying to consistently gloss over it. Maybe then people would be more willing to listen to their larger argument.

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