

PRIVATE EQUITY AND ENTREPRENEURSHIP
An Inequitable Match

Suren Dutia
Ewing Marion Kauffman Foundation

October 2012

Ewing Marion
KAUFFMAN
Foundation

PRIVATE EQUITY AND ENTREPRENEURSHIP
An Inequitable Match

Suren Dutia
Ewing Marion Kauffman Foundation

October 2012

Ewing Marion
KAUFFMAN
Foundation

Private Equity and Entrepreneurship: An Inequitable Match

Faced with economic challenges in the United States, we frequently hear in political discourse the virtues of entrepreneurship as a powerful paradigm for innovation and job creation. Unfortunately, despite this well-intended rhetoric, I believe we are paralyzed as a nation by our inability to enact meaningful legislative initiatives that would advance or nurture U.S. entrepreneurship.

The purpose of this paper is to discuss investment options for entrepreneurial ventures and shed light on the appropriateness of private equity as an option by documenting my own first-hand experience as a founding independent director of an entrepreneurial venture that accepted financing from a private equity fund. I also contrast the value proposition of private equity with that required for the success of entrepreneurial and innovative ventures, and argue against the private equity firm investment in entrepreneurial ventures, which at best does not serve the interests of creating successful businesses that nurture innovation and create jobs. The conclusions and insights that follow are based on my years of extensive experience working with many entrepreneurial organizations at all stages of development.

The PE approach

The private equity (PE) industry is an important source of capital for a variety of businesses, including firms experiencing stalling growth, public and private middle-market firms, economically distressed firms, large family-owned businesses looking for liquidity, and large companies seeking buyout financing.¹ However, PE also becomes a financing option for entrepreneurs when they have exhausted all other alternatives.

PE firms have traditionally used the formula of buying companies, loading them up with debt, restructuring them through layoffs, outsourcing, and other cost-saving moves, draining the cash generated by using it to repay the debt, and then reselling the company in public or private markets for a hefty profit. PE often relies on financial engineering to realize outsized returns, regardless of the target company's industry, innovativeness, growth potential, or other metrics. Unfortunately, this strategy significantly stifles the company's potential to invest in new job creation and innovation and pursue other growth opportunities.

Technology innovator meets PE firm: a cautionary example

That was the case with a software company founded to provide an innovative solution to improve quality and lower health care costs for its customers. The company's software and proprietary technology was based on the vision of its founder, who had impressive credentials. When it became evident that a complex enterprise-level solution was required, a chief technology officer (CTO) was

¹ Rogers, S. 2005; Technical Note: The Private Equity Industry. Kellogg School of Management, Fenn. G.W., Liang, N., & Prowse, S. 1995; Prowse S.D.1998. The Economics of the Private Equity Market. Federal Reserve Bank of Dallas, Economic Review Third Quarter.

brought in who also provided some seed capital that enabled further technology innovation. The founder also raised additional risk capital through angel investors and his professional connections. With these additional investments, the technology platform was rebuilt and yielded promising results. A large reputable company soon signed on to become the firm's first major customer.

In 2006, the company ran into a set of challenges, including the departure of one of its cofounders. Despite these setbacks, acquiring its first major customer gave the company and its product much-needed credibility in the marketplace and helped it initiate a dialogue with potential investors for a capital infusion. Although traditional investment options could have been explored, the company had to choose the quickest path to meet its capital needs. Recognizing the company's urgent need for financing, a PE firm decided to invest in early 2007 and became the controlling shareholder.

Once in control, the PE firm engaged in a series of management decisions that proved detrimental to the company's vision and prospects. They hired a CEO who had worked for a large multinational software company—the perfect wrong candidate for the job at hand—underinvested in much-needed innovation and growth, methodically maligned the CTO and side-lined the founder whose vision had created the company.

Despite the fact that the revenue projections were off by at least 50 percent each year and the cost structure was completely misaligned, no one was held accountable. Sales were consistently lower than projected, yet the new owners resisted any change in strategy or management. This PE firm lacked the relevant experience to provide the necessary human capital, which is equally essential, if not more essential, than risk capital in an entrepreneurial venture. The CEO lacked the skills and vision needed to effectively scale the enterprise. The PE firm continued to rely solely on its handpicked CEO and did not consult with the founder, CTO, or board of directors for any guidance to steer the company back on track.

In 2010, after lengthy stalling, the PE firm agreed with the board to terminate the CEO. While the search for a replacement went on, the PE firm's CEO unilaterally chose his chief lieutenant as the acting CEO. This acting CEO conducted business by telephone and seldom physically visited the company headquarters where most operations and staff were housed. The board raised numerous questions about the strategy and even approved a plan to reorganize the company, but was seldom consulted and routinely ignored. Under private equity stewardship, the company became a liability due to its significant lapse in governance, absence of a cohesive strategy, ineffective sales staff, dysfunctional management team, and ineffective day-to-day leadership.

The company's viability was in serious jeopardy without a change in the PE firm's direction and strategy. Faced with these realities, the founder contacted one of the customers, a large health care corporation that had enthusiastically

embraced the company's technology and solution as strategic. This led to a favorable transaction and the health care corporation acquired the company in December 2011—a best-case scenario that rewarded all the stakeholders.

This was a clear example of the mismatch between the principles of a PE firm and those of an early-stage entrepreneurial business focused on growth and innovation. Clearly, this PE firm was unequipped for the task and exacerbated the situation due to its lack of domain expertise and poor management practices. However, in my judgment, applying the PE model to any entrepreneurial venture with disruptive technology would face similar challenges, irrespective of greater experience, good governance practices, or more effective management. As the chairman of the PE firm cited in this example expressed to me a few weeks prior to the exit, “This just isn't our cup of tea.”

Pitfalls of PE financing

The argument for the role of private equity in creating profitable enterprises is that they help make the companies they buy more efficient and create value, and this role should not be vilified. However, private equity's lack of understanding of an entrepreneurial venture's needs in its most innovative, high-growth, job-creating stage, and management of such a company as if it were in its mature, steady-state stage, sacrifices innovation and job creation to turn quick profits.

Primarily motivated by the corporate tax code's preferential treatment of debt-financing (interest on debt is tax-deductible), firms that have been bought out by private equity oftentimes get bogged down by an excessively hefty debt-servicing burden and have a higher probability of going bankrupt. This bankruptcy threat can be aggravated if these companies expend huge management fees, dividends, and bonuses to their private equity owners. Between 2004 and 2011, PE firms heaped more debt on their companies so they could take out a staggering \$188 billion in dividends for themselves, according to Standard & Poor's Leveraged Commentary & Data.² These dividends created no economic value—they just redistributed capital to the private-equity investors that could otherwise have been invested in the companies' growth.³

Private equity also has come under attack for the hefty remuneration paid out to managers and partners. Referred to as “carried interest,” this disbursement gets special tax treatment allowing PE partners to pay an income tax rate of just 15 percent, as opposed to as much as 35 percent.⁴ As a result, PE partners have a strong incentive to generate outsized returns for their investors, rather than focus on investing in companies' innovation and growth. Therefore, private equity firms are increasingly adept at accumulating personal wealth not through real economic growth, but rather by taking advantage of the tax code.

² The Economist, Bain or blessing, January 28, 2012, <http://www.economist.com/node/21543550>.

³ The New Yorker, The Private Inequity, January 30, 2012
http://www.newyorker.com/talk/financial/2012/01/30/120130ta_talk_surowiecki#ixzz1xRK7hLH2.

⁴ USA Today: Gifts from Government Boost Bain and other Buyout Firms, May 29, 2012.

Another cause for concern: creating jobs is not in PE firms' interest. Rather, their mandate is to generate higher risk-adjusted returns. A 2010 World Economic Forum report found that employment tends to drop at companies targeted for takeovers, and PE deals accelerate the pace of acquisitions and mergers, which yield consolidation—and thus job losses—in a given sector.⁵ A recent NBER working paper that studied employment trends for 3,200 leveraged buyouts found that private-equity ownership resulted in more rapid job destruction. Two years after a buyout, employment declines by 3 percent on average. Other research has found that wages do not rise as quickly at PE-owned firms, probably because buyout firms try to control costs after a takeover.⁶

Alternate financing for entrepreneurial ventures

Entrepreneurial and innovative ventures, in contrast, play a vital role in the economy's growth in terms of job creation and innovation—and require risk capital. From 1980–2005, firms less than five years old accounted for all net job growth in the United States.⁷ For most such ventures, three types of investors are widely tapped: friends and family, angel investors, and venture capitalists. The U.S. venture capital (VC) industry has traditionally played an important role by providing guidance and risk capital required for building high-growth companies. VC-backed entrepreneurial companies account for more than 12 million jobs, or 11 percent of total private-sector employment. However, in the aftermath of the 2008 public market collapse, funds available to VCs have fallen from \$32 billion to 1994–98 levels of \$16 billion. As a result, the number of VC firms has gone from 1,100 to less than 500. Faced with significantly reduced investment dollars, VCs have been forced to protect their portfolio companies and tend to prefer investing in later stages of entrepreneurial ventures.

The increased awareness of the entrepreneurship model, combined with many entrepreneurs who have sold their businesses and have capital available, has created an opportunity for private individuals to step in and fill the void to fund early stage ventures. The growth and importance of angel groups cannot be overemphasized. According to data from the Center for Venture Research and the Ewing Marion Kauffman Foundation, during the ten-year period from 1999 to 2009, the number of angel groups in the United States has grown from about 100 to 300.

Another relevant source of growth capital for entrepreneurial ventures is strategic partners—private or public companies that invest directly or co-invest with VCs in ventures that can add strategic value. While debt financing also might be an

⁵ Dallas News, Private equity deals both create, destroy jobs, January 20, 2012, <http://www.dallasnews.com/news/politics/perry-watch/headlines/20120120-private-equity-deals-both-create-destroy-jobs.ece>.

⁶ 'Venture Impact: The Economic Importance of Venture Capital-Backed Companies to the U.S. Economy' (National Venture Capital Association, 2009)

⁷ Business Dynamics Statistics Briefing: Jobs Created from Business Startups in the United States

option, most startups don't have tangible assets such as inventory, accounts receivable, or capital equipment, and hence this is not a likely option for most entrepreneurial ventures. In a nutshell, VCs, angel investors, and strategic partners have the appropriate level of risk tolerance and can provide the appropriate risk capital and guidance for innovation-driven entrepreneurial ventures to succeed, all the way from seed/early stages to later growth stages.

Conclusion

Where does this leave us in considering private equity's role in creating entrepreneurial ventures? In principle, private equity serves a well-founded purpose of reviving weak companies that may have lost their competitive edge and potentially generating economic growth. However, faced with dwindling investment opportunities, PE firms have drifted into areas outside their comfort zone that have been traditionally well-served by angel investors and VCs. PE clearly is not appropriate for entrepreneurial, innovative, high-growth, risky ventures as it just doesn't have the appetite for the level of risk inherent in innovative high-growth entrepreneurial ventures.

In conclusion, PE firms today are an inequitable match for high-growth and innovative entrepreneurial ventures, and should only be considered a funding source of last resort.

About the author

Suren Dutia is a senior fellow at the Ewing Marion Kauffman Foundation and the Skandalaris Center at Washington University in St. Louis, and serves on the boards of several entrepreneurial ventures. Previously, he served as CEO of TiE Global and chairman and CEO of Xscribe Corporation.