# CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preface</td>
<td>1</td>
</tr>
<tr>
<td>Tax Strategies for 2019</td>
<td>2</td>
</tr>
<tr>
<td>Investors and Funds Adjust Their Footing to Move in a More Cautious Market</td>
<td>3</td>
</tr>
<tr>
<td>Helping to Unlock Real Value in Real Estate</td>
<td>4</td>
</tr>
<tr>
<td>Foreign Investment</td>
<td>5</td>
</tr>
<tr>
<td>Multifamily Real Estate Outlook Remains Positive</td>
<td>6</td>
</tr>
<tr>
<td>Strategy for Today’s Complex Homebuilding Market</td>
<td>7</td>
</tr>
<tr>
<td>Hotels</td>
<td>8</td>
</tr>
</tbody>
</table>
PREFACE

As the commercial real estate market heads into the second quarter of 2019, valuations and competition for deals continue to test the discipline and strategies of market participants, while economic indicators remain strong and interest rate uncertainty has dissipated. This combination of forces means that the market is less frenetic but no less intense. Indeed, some of that energy is being directed internally, as firms redouble their focus on operations, efficiency and technology, and recalibrate their tax strategy as the dust continues to settle from the Tax Cuts and Jobs Act.

In this edition of CohnReznick’s CRE Insights & Updates, our experts offer their perspective on these developments, as well as provide overviews of trends in fundraising, foreign investment, and key market sectors. CRE Insights & Updates, which will be published throughout the year, replaces our annual CRE Momentum report. This allows us to share our industry observations at a frequency that better matches today’s dynamic real estate market.

As always, we welcome your comments and feedback.

Best regards,

Ronald A. Kaplan
Partner
Commercial Real Estate Industry Leader
TAX STRATEGIES FOR 2019

As regulatory dust settles, investors flock to an opportunity

In 2019, tax strategies for commercial real estate are dominated by challenges associated with necessary adjustments due to the Tax Cuts and Jobs Act (TCJA), the most sweeping tax reform legislation in a generation. While there are several notable provisions regarding deductions and taxable income, two stand out as being particularly important from a tax planning perspective.

**Section 163(j)**

The first is the proposed limitations on business interest expense deductibility under Section 163(j). Though real estate got a much-needed carve-out from the new 30 percent cap, electing out of the deduction limitation requires using the slower alternative depreciation system. Charting an optimal strategy for this tradeoff requires a detailed analysis for every building in an investment portfolio. Residential rental real estate is proving to be the most affected asset class, given that an election out of the 163(j) business interest limitation requires a change in depreciable life from 27.5 to 40 years. The resulting reduction of depreciation expense could eclipse the benefit of deducting all business interest. Other commercial real estate asset classes are experiencing a much less significant change to depreciable lives, from 39 to 40 years, and often the choice to deduct 100 percent of business interest is made. In addition to the immediate depreciation impacts mentioned above, forward-thinking strategy is required to consider upcoming capital improvement plans, refinancing, and capital structure changes to ensure that the 163(j) analysis is comprehensive. The election out of 163(j) is an irrevocable election once made.

**20% Pass-Through Deduction**

The second particularly noteworthy provision is the new 20 percent exclusion from pass-through income in Section 199A. The provision has the potential to provide real estate owners and investors with a sizable tax deduction, but much depends on the W-2 wages paid by the entity distributing the income, among other factors. The guidance issued in mid-January provided some welcome assistance in interpreting more than 400 pages of regulations, but there are still numerous questions that invite differences of opinion even among experienced tax professionals. This year’s tax season will thus be accompanied by an unavoidable level of uncertainty that will likely dissipate only as further guidance is issued and standard practices emerge over the next year or two.

**Opportunity Zones**

For many in the commercial real estate industry, however, the TCJA’s biggest news was the creation of opportunity zones and the associated tax deferment and basis step-up benefits. While opportunity zones are new, they are the latest in a long line of tax incentives that recognize the power of real estate investment to stimulate economic development (although the opportunity zones program reaches past real estate to cover other business investment).

Of course, policy never unfolds in a vacuum, and it will be interesting to see how two factors in particular affect this program’s development. The first is that opportunity zones are being introduced just as socially responsible investing (SRI) is moving from the periphery to the mainstream. Qualified Opportunity Funds – the vehicles that invest in opportunity zones – provide a new channel for the growing numbers of family offices, institutional investors, and others that are embracing SRI strategies.

The second factor lies in the fact that underdeveloped urban areas have been a focus of investment for a full decade before opportunity zones were established. To be sure, the opportunity zone program includes areas that lie outside those that have received attention. But an argument can be made that the program is as much accelerating a process already in place as it is redirecting investment to overlooked areas. This isn’t necessarily a bad thing. But it will be worth noting how the opportunity zones program affects an already competitive market – and the extent to which it achieves its policy objectives.
INVESTORS AND FUNDS ADJUST THEIR FOOTING TO MOVE IN A MORE CAUTIOUS MARKET

Last year’s real estate funds and fundraising patterns showed the market move into a more deliberate and cautious phase. Fundraising contracted somewhat due to concerns about lofty market valuations and the potential for a market correction. A total of 298 real estate funds closed with $118 billion globally, according to preliminary Preqin data. That compares to 406 funds raising $132 billion in 2017. While Preqin expects the 2018 numbers to rise as much as 10 percent in its final tally, that would still leave them below 2017 levels. And the U.S. didn’t escape the decline. In North America, private equity vehicles raised $44 billion last year, down about 30 percent from 2017, according to Private Equity International (PEI).

For those who did invest, tenuous market sentiment helped push them to bigger funds at bigger firms. A sense of investor deliberation was also apparent in the 18 months it took funds that closed in 2018 to do so – a 10-year high, according to Prequin. At the same time, though, 45 percent of those funds topped their targets, a five-year high, and dry powder reached $295 billion.

But if investors moved more cautiously, they were still ready to take on risk when the moment was right. Value-added funds attracted $36 billion globally and opportunistic funds garnered $43 billion, according to Preqin. More conservative core and core-plus funds, on the other hand, brought in a mere $6 billion, a roughly 60 percent plunge from 2017. But the appetite for risk didn’t keep investors away from debt funds, which raised a strong $26 billion. So it appears that investors adopted a barbell strategy, opting for risk at one end of the bar and safety at the other. Tellingly, investors remain committed to the asset class: About 80 percent of institutional investors surveyed by Preqin say they will keep their real estate investments the same or increase them in 2019.

Real estate fund managers seem to hold a similar balance of caution and readiness. While they voice concerns that high valuations and any return of interest rate concerns could make it difficult to produce strong returns, 2019 started with 674 real estate funds seeking $250 billion in funding. That includes the behemoth Blackstone Real Estate Partners IX, with a target of $18 billion, which would make it the largest real estate fund ever assembled by the private equity titan.

As for market sectors, industrial and multifamily have dominated fundraising since 2013, and there are no signs of that trend changing anytime soon. Industrial-oriented funds took in $12 billion last year, and multifamily absorbed $10 billion, according to PEI.

Meanwhile, the trend toward crowdfunding continues apace. Regulation A+ of the 2012 Jumpstart Our Business Startups (JOBS) Act has led family offices and high-net-worth individuals to invest in real estate funds of up to $50 million. Another business model that has proven popular allows accredited investors to invest in specific real estate assets. In December, a major development in New York City’s Times Square attracted about $400 million from UBS Group’s ultra-high-net-worth and family office clients. The traction achieved by this new fundraising model is a double-edged sword for private equity real estate funds. On the one hand, the money going to these specific projects might otherwise have flowed through funds. On the other, this capital pool provides real estate funds with another source of co-investors. It will be interesting to watch in the year ahead how the market arranges itself to best take advantage of these emerging funding channels.
HELPING TO UNLOCK REAL VALUE IN REAL ESTATE
Pushing past technology adoption to embrace a holistic strategy

Commercial real estate firms today face increasing performance pressure from all sides. The emphasis on efficiency is relentless. Investors demand greater transparency. Commercial tenants expect building owners to be true strategic partners, while residential tenants expect the delivery of a complete lifestyle experience.

In today’s highly competitive environment, it’s no longer effective to have information scattered over hundreds of spreadsheets, or to use manual processes, which provide little transparency, control, or integration. While CFOs rely on new technology to help with back-office systems and upgrades, these technology solutions must be connected across the organization to provide holistic insights into critical business issues and performance gaps.

Identifying where to begin often presents a roadblock, but charting a strategic roadmap is an effective first step. By aligning technology strategy with business goals, an organization can better respond to the demands of today’s ever-changing, competitive marketplace.

Moving past “analysis paralysis”
When it comes to aligning technology with business strategy, the wave of uncertain variables can overwhelm even the most steely eyed CFO – or worse, lead to choosing an expensive piece of technology that doesn’t solve core business issues and falls short of expectations. Solving this dilemma begins with stepping back from the technology altogether and addressing the following five points:

1. **Identify stakeholders** – IT strategy is no longer held solely within the IT department. Depending on the size and structure of an organization, key stakeholders most often include members of the C-suite.

2. **Define business goals** – Whether creating more accurate forecasts, improving operational efficiencies, or providing tenants with more responsive buildings, technology management should align with business goals and operations. Reliance on multiple, nonintegrated IT systems can cloud visibility into processes and performance. Similarly, it’s important to include measures to eliminate organizational silos to better integrate the processes, data, and goals across lines of business.

3. **Address external market conditions** – To identify current and future opportunities in technology, organizations should preemptively prepare for market disruption and shifting industry realities.

4. **Manage for change** – When technology implementation is perceived as just another initiative with a limited shelf life, the entire endeavor can become a missed opportunity for real change. IT initiatives are only as successful as the change management behind the effort. CFOs and related business leaders should be prepared to continually manage the cultural uncertainties that accompany strategy revisions and recognize that change is a constant.

5. **Educate users** – To optimize the true value of a technology investment, organizations should build in education to ensure that the new technology is well understood and effectively adopted by users.

**Forging ahead**
Whether a company needs to transform its entire technology ecosystem or implement a single business solution, companies that can shift from a reactive approach to strategic planning will be better poised for growth. The range of challenges can seem daunting, but a well-planned roadmap based on business objectives and corporate culture can help organizations look at each opportunity as a chance to improve decision-making and drive performance.

By approaching strategy holistically, the work done now can create a scalable and adaptable platform that can grow with the firm. As a data-driven ecosystem emerges, newly connected operations will empower departments to shift value creation from managing square footage to identifying strategic business opportunities and uncovering unchartered competitive advantages.
FOREIGN INVESTMENT

In the face of challenges, a new generation steps to the fore

For the past several years, foreign investors – from sovereign wealth funds to syndicates of foreign high-net-worth individuals – have been a reliable component of the U.S. commercial real estate investor base. The trend appears to have continued into 2019, but with some important caveats.

First, there are now various impediments to the inbound flow of foreign capital. The sustained drop in oil prices has slowed investment from the Middle East, and Chinese investors are facing their government’s tougher stance on both anti-money laundering enforcement and restrictions stemming from capital flight concerns. Last year, the Committee on Foreign Investment in the United States introduced new legislation that puts certain real estate investments by foreign entities under potential regulatory review – not necessarily a deal-breaker but enough to put some foreign investors at a disadvantage during the bidding process.

Then there are market dynamics with which to contend. Property prices in the U.S. have reached the point where it is becoming increasingly difficult to generate required levels of return, particularly after management fees are taken into account. The turbulence caused by Brexit and other disruptions has created a wider range of viable investment alternatives elsewhere. Uncertainty over interest rates plus the unsettled political environment in Washington do not help.

But as is common, there are those who see opportunity in challenge. In the last several years, we’ve seen the rise of a new generation of foreign investor. Often the second or third generation in their family firm, these investors are generally educated at top U.S. colleges and business schools, and their classmates now head development projects and run the acquisitions departments as sponsors. What’s more, the education of these foreign investors typically happens to be in or near the secondary cities that have fostered dynamic real estate markets over the last decade, such as Raleigh-Durham, Austin, and Charlottesville. This combination of relationships and firsthand geographic knowledge has allowed these younger, highly sophisticated foreign investors to forge deals directly with sponsors and developers here, sidestepping the offshore sponsors that have been the traditional link between foreign capital and U.S. investment.

This combination of relationships and firsthand geographic knowledge has allowed these younger, highly sophisticated foreign investors to forge deals directly with sponsors and developers here, sidestepping the offshore sponsors that have been the traditional link between foreign capital and U.S. investment.

Given this, we expect foreign investment to continue at a steady pace, with midmarket investors and family offices playing an increasingly important role in the capital mix. U.S. developers and sponsors should respond accordingly by courting these foreign investors more directly than they have in the past. Working back through the networks of their thirty-something executives is a good place to start. Doing so can solidify relationships with key sources of funding both now and for the future.
MULTIFAMILY REAL ESTATE OUTLOOK REMAINS POSITIVE

Last year, the multifamily sector continued the remarkable run that helped spearhead the recovery of the commercial real estate sector after the global financial crisis. As we’ve moved into 2019, many of the underlying positive forces remain. There is still considerable opportunity to be found in building properties targeted to millennials and empty nesters. While some millennials have shifted into homebuying, lingering student debt and upward pressure on interest rates continue to put homeownership out of reach for many. For them, amenity-filled apartment buildings in urban work/play/live areas or suburban transit hubs offer an alternative American dream. Indeed, the communal living spaces cropping up in major urban areas are merely the logical extension of a long-running trend in which personal square footage takes a back seat to extensive common areas. The long-term staying power of this shift remains to be seen but bears close watching, given changing norms of ownership in everything from transportation to workspace.

This year will see a large swath of new multifamily projects exit construction and come online; starting next year, we expect construction to slow as traditional lenders — already conservative on construction — further pump the breaks on financing. The many private equity and institutional investors that still want to participate in the multifamily market will continue to push into new avenues for doing so, such as senior housing and age-restricted developments. Workforce housing, which has struggled for attention in recent years, may become an attractive way for investors to enter (or strengthen their holdings in) otherwise pricy secondary markets.

One trend that we expect to see continue applies multifamily investment strategies to single-family homes, with private equity firms and hedge funds acquiring tens of thousands of single-family homes as rental properties; the rental income becomes a securitized asset that can be offered on the secondary market, giving rise to single-family rental REITs. While still a small asset class, it has begun to reach critical mass and develop its own following among investors.
STRATEGY FOR TODAY’S COMPLEX HOMEBUILDING MARKET

Today’s housing market poses a number of risks for homebuilders, but the current environment also creates opportunities for those who can find them. Large builders are leveraging their economies of scale and access to lower-cost capital to generate additional market share at the expense of smaller competitors, who are responding by creating and exploiting expertise in niche segments of their markets.

Today’s challenges
The challenges facing builders start with construction costs, which are rising at a much higher rate than inflation, fueled by tariffs on steel, aluminum, lumber, and other core housing materials. A second hurdle comes from obtaining finished residential lots, which can account for as much as 20 to 40 percent of the total building cost, depending on location. The cost of those lots has grown in tandem with the underlying compliance costs of local building and zoning regulations, which can add up to 25 percent of the cost of a typical single-family home. Infrastructure costs, county fees, entitlement fees, and so on also have increased, with permits sometimes costing more than $100,000. All this has resulted in a dearth of finished lots, while making those lots that are available substantially more expensive.

First-time buyers seek shelter but are price sensitive
Rising building costs have made it challenging for the industry to profitably produce more affordable homes—precisely the ones most in demand by millennials, many of whom are now starting families. But while builders are counting on millennials to drive growth, and while more millennials are purchasing, they’re also highly price sensitive. Having seen from their parents where financial overreach can lead, this cohort has developed a great deal of financial discipline and a practical, no-nonsense mindset. As first-time buyers, they are seeking a place to live rather than the aspirational homes in which they grew up. (Their empty-nester parents, of course, make up the second notable homebuying cohort—but they bring their own challenges, including numerous demands that often slow the closing of the deal.)

Numerous options to achieve profitability
The first priority for many builders then is to find the locations where they can walk this tightrope and create an attractive product for first-time buyers while still turning a profit. Others, however, are turning to the growing market in single-family rentals. While the details vary with geography, single-family rentals generally allow developers to produce a profitable product in high demand, investors to generate strong returns, and residents to choose from a range of new and affordable housing options. Indeed, the opportunities in single-family rental now attract institutional private equity investors and their developer partners, who have replaced an earlier generation of mom-and-pop investors. Thoughtful residential land developers now are integrating neighborhoods of single-family rental residences into their master planned communities. In fact, entire communities of single-family rental housing are cropping up for those who can’t afford to buy or are reluctant to do so.

In the current uncertain housing environment, resilience is key to long-term success for builders large and small. Builders need to address two critical questions: what could go wrong that could cause my company to fail, and how do I effectively compete and create value over the long term? Answering those questions can provide a strategy for growth amid today’s opportunities and challenges.
HOTELS

As we reach the top of the market, preparing for what’s next

The hotel sector has headed into 2019 with much of the same momentum as during the previous two years, with occupancy rates absorbing roughly the 2 to 2.5 percent annual growth in supply. The stamina of the current cycle validates the discipline that both lenders and brands imposed to keep development steady but in check. But the current equilibrium between supply and demand – combined with macroeconomic turbulence from relatively slow economic growth, conflicting signals on interest rates, and a divided government presiding over a shutdown – signals that the sector may well be nearing the end of the dramatic expansion of the last several years.

Now is the time to look at properties with a critical eye to ensure that they are operating with maximum efficiency and are poised to be on the strongest possible footing for whatever conditions develop. This strategic audit should include having a clear sense of the market and customer base.

With that turbulence on the horizon, hotel owners should focus on scrutinizing their operations, making it a top priority for the first half of 2019. When times are flush, it’s easy to let inventory cost control become less stringent and workforce numbers creep up. Now is the time to look at properties with a critical eye to ensure that they are operating with maximum efficiency and are poised to be on the strongest possible footing for whatever conditions develop. This strategic audit should include having a clear sense of the market and customer base. For while macroeconomic conditions set the overall business environment, success in the hotel industry depends on local factors – including having a solid revenue management team, a clear value proposition, and strong relationships with the local community.

Ensuring that the house is in order also makes the property more attractive to potential buyers. With the market cresting, some owners may decide this is the time to take some money off the table – or at least test the waters. In that case, an operational review should be accompanied by a close examination of the property’s finances, as well as its internal controls and reporting systems so that due diligence can be responded to quickly and confidently.

Most owners, of course, will elect to hold their properties; downturns are an inevitable part of the business. So is refinancing. Banks and institutional investors provide a baseline level of funding, but filling the remaining equity gap is the real test of the ability to manage the capital stack. Over the last year, we have helped facilitate several refinancings involving family offices. Unlike institutional investor fund managers, who tend toward specialization and proven formulas, family offices often have an entrepreneurial, opportunistic mindset and a longer-term time horizon, making them attractive investment partners for this dynamic asset class. However, that entrepreneurial and opportunistic approach also means that they are likely to have less hotel-specific experience and more questions than other investors – particularly as they come to appreciate that real estate is only one facet of a hotel investment. Owners and developers may thus find themselves giving master classes on the many moving parts that contribute to a property’s bottom line. And while family offices might be willing to invest with longer-term horizons, they will still want to see a clear exit strategy. Owners and developers who are willing to put in some extra effort, however, are likely to be rewarded with long-term – and highly networked – financial partners.
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ABOUT COHNREZNICK

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PERE 100 methodology

The 2019 PERE 100 ranking is based on the amount of private real estate direct investment capital raised by firms between January 1, 2014 until April 1, 2019.

Where two firms have raised the same amount of capital over this time period, the higher PERE 100 rank goes to the firm with the largest active pool of capital raised since 2014 (i.e., the biggest single fund). If there is still a ‘tie’ after taking into account the size of a single fund, we give greater weight to the firm that has raised the most capital within the past year. We give highest priority to information that we receive from, or confirm with, the private real estate firms themselves. Otherwise, we verify figures, if possible, through independent sources. Some details simply cannot be verified by us, and in these cases, we defer to the honor system. In order to encourage cooperation from private equity firms that might make the PERE 100, we do not disclose which firms have aided us on background and which have not. Lacking confirmation of details from the firms themselves, we seek to corroborate information using firms’ websites, press releases, limited partner disclosures, etc.

What counts?

Structures
• Limited partnerships
• Co-investment/side car vehicles
• Seed capital or manager commitments

Strategies

• Opportunistic
• Value-add

What does not count?

• Expected capital commitments
• Open-ended funds
• Public funds
• Funds of funds
• Non-discretionary vehicles
• Secondaries vehicles
• Core
• Core-plus
• Private equity
• Infrastructure
• Hedge funds

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PRIVATE EQUITY’S GOVERNANCE ADVANTAGE: A REQUIEM

ELISABETH DE FONTENAY*

ABSTRACT

Private equity’s original purpose was to optimize companies’ governance and operations. Reuniting ownership and control in corporate America, the leveraged buyout (or the mere threat thereof) undoubtedly helped reform management practices in a broad swath of U.S. companies. Due to mounting competitive pressures, however, private equity is finding relatively fewer underperforming companies to fix. This is particularly true of U.S. public companies, which are continuously dogged by activist hedge funds and other empowered shareholders looking for any sign of slack.

In response, private equity is shifting its center of gravity away from governance reform, towards a dizzying array of new tactics and new asset classes. Large private equity firms now simultaneously run leveraged buyout funds, credit funds, real estate funds, alternative investments funds, and even hedge funds. The difficulty is that some of the new money-making strategies are less likely to be value increasing than governance and operational improvements. Moreover, they introduce new conflicts of interest and complexities that alter private equity’s role in corporate governance. Private equity’s governance advantage has always been to ensure that companies are the servant of only one master. Yet today the master itself may have divided loyalties and attention. With few gains left to be had from governance reforms, private equity is quietly distancing itself from the corporate governance revolution that it helped bring about.

* defontenay@law.duke.edu. Joseph Hahn provided outstanding research assistance. All errors are mine.
INTRODUCTION

Every business school student in the United States has heard some version of the following tale, designed to show that private equity ownership is superior to the public-company governance model. It begins with a description of the pre-1980s bad old days, in which entrenched, lazy, and cash-hoarding management went unchecked in public companies, while passive shareholders could only look on in dismay.1 But lo, private equity emerged as a knight in shining armor, reuniting ownership and control in corporate America and turning bloated, inefficient companies into slimmed-down cash machines.2 It is a nice tale—for shareholders, certainly—but one that may no longer be true, because along the way both private equity and public companies have changed.

Take public companies. The rise of institutional investors, the widespread adoption of the shareholder value gospel, and the flourishing market for corporate control have put a stake in unrepentant managerialism. Most visibly, hedge fund activists began seriously taking American management to task in the 2000s and never looked back.3 The threat of activist campaigns has altered management practices not only at the firms they target, but at most public firms.4 While U.S. public companies today are far from perfect, they can no longer get away with merely gesturing toward shareholder interests.5 As others have noted, there are diminishing marginal returns for corporate governance improvements in any given firm,6 and for most firms and most industries, it appears that we are already close to the plateau.

At the same time, private equity’s business model has changed almost beyond recognition. The classic private equity strategy is the leveraged buyout (“LBO”),

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1 See Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 AM. ECON. REV. 323, 323 (1986) (describing agency problems in large public corporations in the 1980s, including management’s incentives to retain too much cash in the corporation, rather than returning it to shareholders).


4 See DELOITTE, CFO SIGNALS: WHAT NORTH AMERICA’S TOP FINANCE EXECUTIVES ARE THINKING—AND DOING 3 (2015) (“About half of CFOs say their companies have made at least one major business decision specifically in response to activism.”); Nickolay Gantchev, Oleg R. Gredil & Chotibhak Jotikasthira, Governance Under the Gun: Spillover Effects of Hedge Fund Activism, REV. FIN., Nov. 16, 2018, at 1, 1 (discussing how threat of hedge fund activism impacts behavior of non-targeted firms).


in which the fund acquires a public or private company, levers up its capital structure, makes operational improvements, and then sells the company or takes it public after a few years.\(^7\) The potential governance advantages of LBOs are many, including the sponsors’ willingness to cut costs and replace management, the disciplining effect of high leverage, the careful monitoring provided by a small, incentivized board that meets frequently, and so on.\(^8\) The private equity model is getting squeezed on all sides, however. The newly reformed crop of public companies means that there are simply fewer gains to be had from improving U.S. companies’ governance and operations by taking them private; activist hedge funds and other institutional investors have already done the heavy lifting. Tellingly, the major studies showing that LBOs have a positive impact on firms’ governance and operations tend to draw data from earlier decades or from abroad,\(^9\) with rare exceptions.\(^10\)

Meanwhile, private equity is also struggling to find private targets to acquire and improve. Large companies today are finding it easier to grow through acquisitions than organically.\(^11\) These so-called “strategic” acquirers are snatching up private firms eager for capital that in the past would have been ideal candidates for private equity acquisitions.\(^12\) Separately, venture capital funds are expanding into fields beyond tech, holding onto portfolio companies for longer, and even becoming comfortable with debt financing, further crowding out private equity.\(^13\) Unlike with its public-company targets, private equity surely still shines at improving governance and operations in small, private companies—particularly family-owned businesses.\(^14\) The question is whether

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8 See id. at 130-32.
12 Id.
14 See Bloom, Sadun & Van Reenen, supra note 9, at 444 (finding that private equity-
these firms can be reached before others swoop in. While private equity today is awash (and perhaps drowning) in cash,15 so is everyone else. That means firm valuations are soaring, making it less likely that private equity will find attractive targets and that its returns will remain high for much longer.16

These competitive pressures are already manifesting in the data. A growing body of empirical studies finds that private equity returns are substantially lower than sponsors generally claim.17 More revealing still, the return data show that private equity investments now perform either worse than, or no better than, leveraged investments in public equities.18 Simply put, private equity’s primary contribution to U.S. firms today appears to be cheap debt financing, rather than governance, strategy, and operations.19 Nowhere is the decline of the traditional private equity approach more obvious than in its failures in the retail industry, culminating painfully in the 2017 bankruptcy of Toys “R” Us.20

owned firms employ superior management practices to family-owned firms, but not to public companies with dispersed share ownership).

15 See Javier Espinoza, Private Equity Funds Active in Market Reach All-Time High, FIN. TIMES (Apr. 25, 2018), https://www.ft.com/content/c74e10c6-47d2-11e8-8ae9-4b5ddca99b3 (describing record-breaking fundraising by private equity funds).


18 See Ang et al., supra note 17, at 1782 (concluding that volatility for private equity is at least as high as for standard equity indices, and that private equity is akin to a levered investment in small and mid-cap equities); Daniel Rasmussen, Private Equity: Overvalued and Overrated?, AM. AFF., Spring 2018, at 4.


20 See Paul Sullivan, 3 Investments That May Have Hit Their Peak, N.Y. TIMES (Sept. 14,
making the major investments needed to transition brick-and-mortar retailers into the e-commerce age, private equity funds combatted their lower prospects of generating returns by doubling down on the use of leverage.21

Indeed, private equity firms appear to be responding to their newly competitive environment not by increasing their efforts at governance, but by switching tactics to drive returns and even branching out into new asset classes.22 Large private equity firms now simultaneously run LBO funds, credit funds, real estate funds, alternative investments funds, and even hedge funds.23 They create new industries by pushing for the privatization of traditional government services.24 In a stunning role reversal, they have even begun underwriting major corporate loans.25 Along the way, even their own governance structure has changed: several of the largest private equity firms are now themselves public companies26—a tacit acknowledgment by the industry that private ownership is not destiny for all firms. All this is to say that “private equity” has become a misnomer for the industry.

Ironically, in comparison to governance and operational improvements, these new strategies may in fact play better to the built-in advantages of the larger private equity firms: extraordinary financial sophistication; deep and lucrative connections to financing sources; and, perhaps, the ability to time markets.27 Nor should we be surprised at how quickly the private equity industry is evolving: its compensation scheme incentivizes private equity managers to pursue returns regardless of their source.28

The difficulty is that some of the new money-making strategies are less likely to be value increasing than the traditional governance optimization approach.29


21 See id.

22 See infra Section III.A.


27 See Kaplan & Strömberg, supra note 7, at 123.


29 See infra Part III.
Moreover, they introduce new conflicts of interest and complexities that alter private equity’s role in corporate governance. Private equity’s governance advantage has always been to ensure that companies are the servant of only one master. Yet today the master itself may have divided loyalties and attention. With few gains left to be had from governance reforms, private equity is quietly distancing itself from the corporate governance revolution that it helped bring about.

This Article proceeds as follows. Part I describes the heyday of private equity’s traditional strategy of optimizing firms’ governance and operations. Part II explains how competition from inside and outside the industry is pushing private equity away from its traditional focus on governance. Part III briefly describes how private equity has altered its strategies and how the resulting complexity and new conflicts of interest create uncertainty as to private equity’s role in corporate governance going forward.

I. THE TRADITIONAL GOVERNANCE APPROACH: THE GOLDEN AGE

Private equity has undeniably played a key role in the dramatic transformation of U.S. corporate governance over the last few decades. Beginning with the very first major LBOs in the 1980s, private equity’s salvo signaled the beginning of the end of uncontested managerialism in the United States. Public companies were put on notice that even if their shareholders were asleep at the wheel, they would nonetheless have to pay heed to shareholder value or risk a takeover. In the so-called middle market, by contrast, private equity firms generally targeted private companies lacking financial and managerial experience. Family-owned businesses, for example, made highly attractive targets for LBOs, ideally combining a sound business model with inefficient operations or an inefficient capital structure.

In both cases—the massive public-company LBO and the acquisition of smaller private companies—private equity ownership could result in major improvements in the target company. This Part briefly describes this ideal version of private equity, in which private equity firms make substantial value-increasing contributions to their portfolio companies’ governance and operations.

30 See infra Part III.
33 See Bloom, Sadun & Van Reenen, supra note 9, at 442 (using survey evidence to show that private equity-owned companies adopt better management practices than similar family-owned companies).
A. Efficient Governance

When Professor Michael Jensen predicted the “[e]clipse of the [p]ublic [c]orporation” in 1989, he did so with private equity in mind as the ideal alternative governance model for firms. Ever since Berle and Means published their classic treatise on corporations, the perceived defect of public company governance has been the problem of the separation of ownership and control. While raising capital from the general public can lower a firm’s cost of capital and allow it to reach significant scale, it is incompatible with investors themselves managing the firm. Equityholders must instead delegate management of the firm to hired managers. While unquestionably more efficient than management by dispersed shareholders, delegated management introduces its own problem, referred to as the agency costs of management. Because dispersed public-company shareholders have little incentive or ability to monitor management closely, managers have the opportunity to privilege their personal interests over shareholders’ interests.

The birth of private equity offered a brilliant solution to this conundrum: private equity funds were able to raise or borrow enough capital to finance even very large companies, without resorting to dispersed share ownership. Typically, a private equity firm (or “sponsor”)—a team of investment professionals—forms a fund to pool equity capital, primarily from institutional investors. The fund then uses this capital, along with a large proportion of borrowed funds, to acquire and hold portfolio companies for several years. Although the private equity fund may have a large number of investors, the fund itself serves as the sole equity owner of each portfolio company, and decision-making by the fund is in the hands of a single manager: the private equity sponsor.

Thus, in Jensen’s view, private equity acquisitions had the considerable advantage of reuniting ownership and control in large firms, by replacing dispersed shareholders with a sole owner that was also the sole manager. To be sure, this description of private equity was in some respects inaccurate even at the time when Jensen was writing. Private equity firms do not actually run their

34 Jensen, supra note 2, at 61.
37 Id. at 308-09.
38 See Kaplan & Strömberg, supra note 7, at 123. For a comprehensive description of, and justification for, the structure of investments funds—including private equity funds—see John Morley, The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation, 123 YALE L.J. 1228 (2014) (explaining why investment pools and their managers are segregated into different entities).
39 Leverage is a key feature of private equity investments. Anywhere from thirty to seventy percent of the target company’s capital structure will be comprised of loans or bonds issued by the target in connection with the acquisition by the private equity fund. See Kaplan & Strömberg, supra note 7, at 124-25.
portfolio companies on a day-to-day basis; they delegate to hired officers just as
public-company boards do.40 Yet by staffing the board, they are at least directly
responsible for key decision-making and the hiring and oversight of the officers.
Described below are the various governance contributions that private equity
firms can make to their portfolio companies, in the ideal case.

1. Better Monitoring

With private equity, dispersed, passive shareholders are replaced by a single
shareholder that has the resources and incentives to monitor corporate officers
closely.41 First, private equity portfolio company boards look and behave
differently than public-company boards.42 The former are smaller—composed
exclusively or primarily of principals of the private equity firm—and they meet
comparatively frequently.43 Most importantly, unlike directors serving on
public-company boards, the economic stakes for directors of private equity
portfolio companies are very high. Private equity firms generally staff the board
of a portfolio company with the lead principals responsible for the investment,
and they intentionally tie these principals’ compensation closely to the portfolio
company’s success.44

In addition, private equity has a built-in mechanism to ensure that managers
remain disciplined: the heavy debt loads that they impose on their portfolio
companies. Unlike public-company managers in Michael Jensen’s caricature,
who oversee bloated corporate empires flush with cash, the discretion of
portfolio company officers is severely constrained.45 With major debt payments
always looming on the horizon, officers must manage cash carefully and operate
as leanly as possible.

2. Better Incentives

Much of the claimed difficulty with dispersed share ownership in public
companies lies in the divergence between the incentives of shareholders and
those of managers. By contrast, the private equity model does much to realign
the incentives of corporate officers with those of the shareholder (the private
equity fund, and, indirectly, the institutional investors invested in the private
equity fund). Evidence suggests that: (1) they are willing to pay managers more,

40 See Zohar Goshen & Richard Squire, Principal Costs: A New Theory for Corporate Law

41 See Bloom, Sadun & Van Reenen, supra note 9, at 442-43 (concluding that private
equity ownership is associated with improved monitoring, based on survey data from thirty-
four countries).

42 See Francesca Cornelli & Öguzhan Karakas, Private Equity and Corporate
Governance: Do LBOs Have More Effective Boards?, in 1 GLOBALIZATION OF ALTERNATIVE
INVESTMENTS WORKING PAPERS VOLUME 1: THE GLOBAL ECONOMIC IMPACT OF PRIVATE

43 See id. at 66.

44 See id. at 72-73.

45 See Jensen, supra note 1, at 324 (describing how firm leverage can be used to constrain
management and thereby reduce agency costs).
as a percentage of the value of the business, than public-company shareholders; (2) the compensation is more heavily tilted toward equity compensation, creating “high-powered” incentives for managers; and (3) vesting and payout are tied to major liquidity events for the company, prompting all parties to work toward a favorable exit for the private equity fund.46

B. Efficient Operations

Private equity firms do not pursue good governance for its own sake. The goal, of course, is for private equity’s governance advantage to translate into an advantage in firm value, including through greater operational efficiency. This is the theory of private equity most often promoted by the industry itself and its proponents: private equity ownership leads to more efficient firms.47 There are several plausible paths from governance to firm value in this case. First, better incentivized, smaller, and more focused boards might make better strategic decisions for the firm, with respect to major corporate events such as mergers and acquisitions (“M&A”) and product lines.48 Second, private equity firms may be more willing than typical management to make difficult decisions that improve operational efficiency, such as approving layoffs, spinning off underperforming divisions, and even replacing top executives.49 Most significantly, private equity firms are incentivized by their compensation arrangement with their own investors to maximize their portfolio companies’ leverage,50 something that public-company managers have been more reluctant to do. Because managers at public companies may lose not only their jobs but a significant portion of their wealth (assuming that they hold company stock) if their firm goes bankrupt, they have incentives to keep the firm’s leverage low


48 See supra note 42-44 and accompanying text.

49 See Kaplan & Strömberg, supra note 7, at 132 (describing one study’s finding that in private equity portfolio companies with poorly performing management, “one-third of chief executive officers . . . are replaced in the first 100 days while two-thirds are replaced at some point over a four-year period”). Unlike other corporate management, private equity firms tend not to have any personal stakes or close personal relationships in their portfolio companies, because they do not found companies and because they acquire companies with the intention to exit the investment within a few years.

50 Private equity firms typically receive a significant portion (e.g., twenty percent) of the profits from any of their funds’ investments, but do not bear any losses. Id. at 123-24. This option-like compensation rewards risk-taking by the private equity firm, including through tactics such as using leverage. See id.
relative to the optimum predicted by finance theory. In this view, private equity firms are more likely to optimize a firm’s capital structure than public-company managers, thereby capturing the tax advantages of debt financing over equity financing and necessitating lean operations.

Thus, the ideal of private equity-style corporate governance is a model in which the incentives of owners and managers are tightly aligned, the owner closely monitors the corporate officers, and the private equity firm brings expertise and efficiency to the firm’s capital structure and operations. The next Part describes how intense competition from within and without the private equity industry means that private equity’s traditional governance strategy should no longer be expected to generate the same high returns as in prior decades, and that the space for private equity sponsors to make governance improvements in the first place has narrowed considerably.

II. COMPETITION IN THE LBO SPACE: ANYTHING YOU CAN DO I CAN DO BETTER

By many measures, it is the best of times for private equity. Now considered an established asset class, private equity attracts substantial allocations of capital from institutional investors of all types. Recent fundraising continues to break records, leaving many sponsors to turn away investors’ money rather than chase it. And while interest rates may be inching upward as U.S. monetary policy tightens, they remain low by historical standards, allowing private equity funds to make the highly levered acquisitions that the private equity business model envisions.

Upon closer inspection, however, private equity today appears to be a victim of its own success. Competition from inside and outside the asset class threatens both its highly touted returns and its governance advantage.

Within the industry, the number of private equity funds and investor inflows continue to skyrocket. If the funds raised outpace the value-increasing opportunities for private equity investments, as many observers now claim is likely, then investor returns will necessarily decline. Private equity is well past

51 See Jensen, supra note 1, at 324 (explaining why public-company management has private incentives to minimize their firms’ debt loads); Kaplan & Strömberg, supra note 7, at 140-41 (finding that private equity-owned companies use more debt in their capital structure than comparable public companies).

52 See Kaplan & Strömberg, supra note 7, at 134-35, 140-41. It is often also claimed that private equity firms increase operational efficiency by contributing their own expertise or by hiring industry experts to join the executive teams of their portfolio companies. This advantage is somewhat less plausible, however. It is unclear why private equity principals primarily trained in finance would have an advantage in achieving operational efficiency over public-company managers with significant industry experience or with equal access to external experts.


54 Id. at 3, 29.

55 See Espinoza, supra note 15.

56 See id.
its halcyon days as a small, select club of sponsors that could not avoid making money if they tried. Today’s private equity industry is a crowded space indeed, running the gamut from one-person shops to the massive fund groups. Competition among buyout funds for acquisition targets is so severe that the industry is struggling to deploy the staggering amounts of capital (or “dry powder”) that it has raised.57 As one would expect for an increasingly competitive industry, the empirical evidence suggests that the private equity industry’s longer-term trends are towards lower returns (or, more precisely, returns similar to those of investing in public companies).58

To be sure, while greater competition among private equity sponsors means lower returns, it does not necessarily follow that sponsors will devote less attention to governance in the aggregate—just as lower profits for producers in any competitive market do not entail less production overall. A better explanation for private equity’s turn away from governance is that there are now fewer opportunities for governance improvements in the first place. Indeed, what has received less attention than private equity’s internal competition is the severe competition that it now faces from outside the industry, in particular from other types of investment funds and from strategic acquirers. This Part describes the key external forces that are chipping away at private equity’s corporate governance advantage.

A. Activist Hedge Funds

If private equity is to generate above-market returns from reforming public companies’ governance, it requires a large pool of public companies with suboptimal governance that are also feasible targets for an LBO.59 Specifically, buyout funds ideally seek mature public companies with stable cash flows; assets that are easy to use as collateral; disloyal, incompetent, or inexperienced management; a suboptimal (e.g., cash-heavy) capital structure; inefficient operations and strategy; and inefficient management compensation schemes. For several reasons, these conditions are significantly less likely to be satisfied than in private equity’s early years. The gradual disappearance of retail investors directly holding stock in public companies means that ownership of public companies today is not only predominantly institutional, but increasingly concentrated.60 As a result, the collective action problems that long prevented shareholders from successfully monitoring management are rapidly dissipating. While early predictions of a wave of activism in the 1990s by institutional investors such as mutual funds proved premature, it is undeniable that institutional investors have flexed their collective muscles since then and profoundly affected public-company governance.61

58 See supra notes 17-18 and accompanying text.
59 See Jensen, supra note 2, at 65.
60 Gilson & Gordon, supra note 3, at 874-75.
61 See id. at 886-87.
Activist hedge funds especially have established themselves as crusaders for shareholder interests, displaying not only the incentives but the ability to monitor public-company managers and to force their hand on key corporate events. For each type of advantage claimed by private equity—governance-related, financial, operational, or strategic—activist hedge funds may plausibly claim to do the same or better.

First, on the corporate governance front, activist hedge funds may make a wide range of contributions. They are well known for toppling underperforming directors and CEOs of even the largest U.S. public companies, using tactics ranging from friendly negotiations with boards to full-blown proxy fights. Further, they arguably improve the functioning of public-company boards. When activist-sponsored candidates serve on boards, they tend to be better incentivized than their fellow directors. And rather than relying solely on management for information, like traditional board members do, activist hedge funds often seek out or even generate their own sources of information, for example by conducting interviews of the target company’s former employees. Separately, they have played a significant role in reducing barriers to shareholder democracy; for example, by campaigning against staggered boards and poison pills.

Second, if private equity’s governance advantage stems largely from its greater willingness to employ leverage, then activist hedge funds are preempting private equity firms here as well. Increased payout to shareholders is a frequent rallying cry for activist hedge funds, and higher payout tends to increase a firm’s leverage, whether or not it is accompanied by new borrowing. Hedge fund activists increase payout ratios by demanding increased dividends or share repurchases (“buybacks”) from the firms they target.

63 To clarify, this Article makes no claims as to the overall social welfare effects of either hedge funds or private equity, which are heavily debated. Rather, the focus here is on their respective impacts on firm value.
64 See Brav et al., supra note 62, at 1732.
66 For example, in its campaign against Darden Restaurants, activist hedge fund Starboard Value interviewed former employees of Olive Garden at length in preparing its white paper criticizing management. See STARBOARD VALUE, TRANSFORMING DARDEN RESTAURANTS 64 (2014), http://www.shareholderforum.com/dri/Library/20140911_Starboard-presentation.pdf [https://perma.cc/L3BX-DEN6].
67 See Brav et al., supra note 62, at 1744. On the other hand, many view the current trend toward dual-class stock—a device that nakedly entrenches corporate insiders—as a reaction to the widespread influence of activist shareholders.
68 See id. at 1771 (discussing the activist strategy of increasing payouts). As shareholder’s equity declines through payout, the portion of the firm’s capital structure represented by debt increases (unless firm is entirely equity-financed, in which case greater payout simply causes the firm to shrink in size). See id.
69 Id.
Third, activist hedge funds may act directly on firm operations, by encouraging cost-cutting measures such as slashing R&D budgets or reducing the firm’s workforce—tactics that are straight from the private equity playbook.70 Activist hedge funds have recently targeted companies such as Apple, DuPont, Google, and Microsoft for their high R&D expenditures.71 The stated rationale for these measures is to remedy managers’ inherent tendencies toward overconfidence, empire building, and other agency problems,72 which is precisely the same rationale originally used to justify LBOs.

Fourth, and finally, like private equity funds, activist hedge funds often push companies to make major strategic decisions, including pursuing M&A transactions and spin-offs.73 Crucially, the zone of influence of activist hedge funds is not limited to the firms that they target. Instead, managers at any public company that is a potential target of an activist campaign have incentives to unilaterally adopt activist-friendly policies—such as high payout, cost reductions, and sales of underperforming assets or divisions—in order to stave off an actual campaign that might result in the loss of their jobs.74 Thus, although the aggregate capital devoted to activist hedge funds is negligible in proportion to the total market capitalization of U.S. public companies, activist hedge funds have had enormous influence on public company governance.

Why is the rise of activist hedge funds problematic for the traditional private equity model? The increasing overlap between the two ultimately decreases investment opportunities for private equity. We need not resolve here whether hedge fund activism actually increases value in public companies—a matter of ongoing dispute—but only note that activist strategies are preempting those of private equity and shrinking the pool of private equity targets. Stated simply, activist hedge funds are leaving private equity firms with fewer public companies to fix.

70 See id. at 1741.
71 Alon Brav et al., How Does Hedge Fund Activism Reshape Corporate Innovation?, 130 J. FIN. ECON. 237, 238 n.5 (2018).
73 For example, hedge funds have pressed McDonald’s and Wendy’s to spin off major assets; induced management changes at Heinz, KT&G, and Time Warner; and pushed for M&A deals between companies such as Euronext and Deutsche Börse, Steve Madden and VF Corporation, and their own acquisitions of firms such as Kmart and Circuit City. See Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. PA. L. REV. 1021, 1024-25, 1029-42 (2007).
B. Venture Capital Funds

While activist hedge funds have made public-company targets less attractive or less available for private equity acquisitions, venture capital funds are doing the same for many private-company targets. Venture capital and LBOs are generally viewed as entirely distinct investment strategies. Venture capital investments are traditionally made in early stage companies, where capital needs are severe, cash flows are highly uncertain and often negative, and debt-financing is therefore precluded. By contrast, private equity funds—referring here to LBO funds—target mature companies with stable cash flows, which are able to take on substantial debt loads. Thus, not only do venture capital and private equity traditionally differ as to what stage in the firm lifecycle they favor, they also differ as to what industries they target: venture capital investments are heavily tilted toward the tech industry, for example, while LBO funds favor industries such as retail.

This division of labor has changed, however, in light of the long-term decline in the proportion of public companies in the United States and the ongoing glut of private capital. Venture capital and private equity are no longer ships passing in the night. With founders choosing to keep their companies private substantially longer than in prior decades, venture capital funds can no longer rely on a rapid initial public offering (“IPO”) exit from their successful investments. Rather, private firms may go through multiple rounds of venture capital financing, with ever longer holding periods, until they finally exit through an IPO or, more likely, a sale to a strategic acquirer.

The upshot is that many firms that, in prior decades, would have been natural targets for private equity acquisitions are today still in venture capital funds’ hands, and the latter show little sign of letting go.

C. Strategic Acquirers

Private equity arguably faces its most severe competition from so-called strategic acquirers—ordinary operating companies (as opposed to “financial”

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77 See id. at 1472.
78 See id. at 1471.
80 See Gao, Ritter & Zhu, supra note 11, at 1672; Scott Kupor, Where Have All the IPOs Gone?, ANDREESSEN HOROWITZ (June 19, 2017), https://a16z.com/2017/06/19/ipos/ [https://perma.cc/2TBU-JXMS].
81 See Gao, Ritter & Zhu, supra note 11, at 1690.
82 More generally, to the extent that we are in the midst of a long-term economic shift away from retail and towards the tech and health care/drug industries—a matter of some debate—then venture capital will increasingly be the funding source of choice for firms.
investors such as private equity funds) that are on the lookout for potential acquisition targets. M&A transactions by strategic acquirers have dramatically outpaced IPOs in recent years; after recovering from the financial crisis of 2008-2009, U.S. companies found themselves with excess cash on their balance sheets, ready to be deployed.\textsuperscript{83} Acquisitions have proven to be a popular strategy; technological change and globalization entail increasing economies of scale and scope for firms,\textsuperscript{84} while relatively weak antitrust enforcement has made industry consolidation attractive.\textsuperscript{85}

In one respect, the rise in strategic acquisitions is good for private equity: big companies overburdened with cash will snatch up portfolio companies when their private-equity-fund owners are looking to sell.\textsuperscript{86} This benefit at the exit stage is more than offset, however, by the fact that strategic acquirers compete with private equity firms to make portfolio investments in the first place.\textsuperscript{87} Because strategic acquirers typically expect substantial synergies (such as economies of scale and scope) or other profit opportunities from an acquisition (such as eliminating a competitor), they can afford to pay significantly more than the current value of the target firm as a stand-alone entity.\textsuperscript{88} Financial buyers such as private equity firms do not have that luxury, because they typically continue to hold the target firm post-acquisition as a stand-alone entity.\textsuperscript{89} It is therefore crucial for their investors’ returns that the private equity fund not overpay for the target from the outset.

But with strategic acquirers lurking around every corner today, private equity firms are regularly competing head-to-head with them for acquisitions, causing private equity firms either to lose out on many investment opportunities or to


\textsuperscript{84} See Gao, Ritter & Zhu, \textit{supra} note 11, at 1664.


\textsuperscript{86} See Han T.J. Smit, \textit{Acquisition Strategies as Option Games}, \textit{14 J. Applied Corp. Fin.} 79, 82 (2001) (describing how exits available to private equity firm under “buy-and-build” strategy are either to sell to strategic buyer or financial buyer or to pursue IPO).

\textsuperscript{87} See Jana P. Fidrmuc et al., \textit{One Size Does Not Fit All: Selling Firms to Private Equity Versus Strategic Acquirers}, \textit{18 J. Corp. Fin.} 828, 829 (2012) (describing differing characteristics and incentives of private equity and strategic buyers).


\textsuperscript{89} See Bartlett III, \textit{supra} note 88, at 2003.
dramatically overpay for them.\textsuperscript{90} With consolidation being the strategy \textit{du jour} in many industries,\textsuperscript{91} strategic acquirers are very likely to set the price in the vast majority of auctions for target companies, which is bad news for private equity.\textsuperscript{92}

Of course, while strategic acquirers have the advantage of synergies, private equity acquirers have traditionally had the advantage of leverage.\textsuperscript{93} Because debt-financing is tax-advantaged relative to equity financing,\textsuperscript{94} and strategic acquirers are relatively less likely to make leveraged acquisitions, private equity firms have at times been able to beat strategic acquirers for attractive targets, despite the absence of synergies.\textsuperscript{95} Here again, however, trouble is looming for private equity. The dramatic decrease in U.S. corporate income tax rates (courtesy of the Tax Cuts and Jobs Act of 2017)\textsuperscript{96} has been heralded by the private equity industry and its advisors as a major boon to the industry simply because most private equity portfolio companies, like all other corporations, will now pay less in tax. This misses a fundamental point, however: lower corporate tax rates mean less of an advantage to debt financing over equity financing,\textsuperscript{97} and therefore less of an advantage to private equity bidders over strategic acquirers. Thus, the boon of the new tax regime is better viewed as a bane for private equity, by making it that much harder for private equity funds to compete with strategic acquirers when bidding for target companies.\textsuperscript{98}

Viewed another way, the M&A market today is all grown up: private equity no longer has an advantage over other players in terms of sourcing deals, optimizing financing and taxation, or otherwise, simply by virtue of having repeated experience with M&A transactions. As a consequence, it will be increasingly difficult for LBO funds to get their foot in the door with the dwindling share of attractive targets.

To summarize this Part, external competition is leaving private equity with fewer opportunities and incentives to pursue governance improvements in U.S.

\textsuperscript{90} See BAIN & CO., \textit{supra} note 16, at 5.

\textsuperscript{91} For example, nearly half of all externally acquired inventions in the pharmaceutical industry are obtained through M&A. See Ashish Arora, Wesley M. Cohen & John P. Walsh, \textit{The Acquisition and Commercialization of Invention in American Manufacturing: Incidence and Impact}, 45 RES. POL’Y 1113, 1113 (2016).


\textsuperscript{93} See Bartlett III, \textit{supra} note 88, at 2017.

\textsuperscript{94} Id. at 1985.

\textsuperscript{95} Id. at 2010-11.


\textsuperscript{97} For purposes of calculating their income tax, corporations may generally deduct interest payments to their debtholders, whereas they may not deduct payments (such as dividends or stock repurchases) to their shareholders. See Bartlett, \textit{supra} note 88, at 1987. Thus, all else being equal, there is a substantial tax advantage to the corporation from financing itself with debt, rather than with equity. Moreover, the higher the then-applicable corporate income tax rates, the greater the amount of tax savings for any given dollar amount of interest payments.

\textsuperscript{98} In addition, the new rules from the Tax Cuts and Jobs Act that limit the deductibility of interest in highly leveraged companies are unambiguously bad for private equity.
companies. The next Part examines private equity’s response to its new competitive environment.

III. CONFLICTS AND COMPLEXITY

In a 2009 article, Professors William Birdthistle and M. Todd Henderson identified the beginnings of a shift in the private equity model, namely an expansion from LBOs into other strategies and even other asset classes.99 The authors further warned of the resulting potential for new conflicts of interest involving private equity sponsors.100 The article proved remarkably prescient—the phenomenon it describes has raised concerns for private equity’s investors and regulators ever since.

This increase in conflicts is only one aspect of the changing face of private equity in response to competition. This Part briefly describes these new conflicts as well as other developments that are likely to alter the industry’s impact on corporate governance. These changes do not simply mean that private equity will likely devote less attention to governance going forward. This Part explains why the new private equity strategies could potentially have an ambiguous or even negative governance impact.

A. Beyond LBOs

Corporate governance was an obvious focal point for private equity firms when their sole investment strategy was to sell companies for more than they paid for them. If better governance caused firm value to increase either directly (by reducing managerial shirking, for example), or indirectly (by leading to more efficient operations), then it would boost private equity returns, and the sponsors’ investment professionals would be incentivized ex ante to chase them.

However, intense competition and the shrinking set of opportunities for governance improvements have prompted the larger private equity firms to branch out from LBOs to other strategies and even other asset classes.101 In fact, private equity sponsors no longer require control of their portfolio investments—they are increasingly content to partner with other investors and to take minority stakes in companies, even public ones.102 Given that monitoring incentives increase and decrease with the size of equity investments103 and that minority investments offer lower returns relative to buyouts,104 we should expect

100 See id. at 54-55.
101 See Tuch, supra note 23, at 340-41.
102 See Guojun Chen et al., Sources of Value Gains in Minority Equity Investments by Private Equity Funds: Evidence from Block Share Acquisitions, 29 J. CORP. FIN. 449, 449-50 (2014); Tuch, supra note 23, at 340-41.
103 See Andrei Shleifer & Robert W. Vishny, Large Shareholders and Corporate Control, 94 J. POL. ECON. 461, 462-63 (1986).
private equity firms to play a lesser role in firm governance for these minority investments.

As discussed, the largest private equity firms now sponsor funds in a wide array of asset classes—anything from real estate to commodity futures. Most strikingly, many now manage both equity and debt funds.105 Apollo, Blackstone, and KKR each have more assets in their credit funds than in their equity funds.106 On the one hand, this reflects a rational response to overcrowding in the LBO space, and it capitalizes on private equity firms’ financial sophistication and ability to navigate the capital markets. On the other, credit funds have very different incentives and require different expertise than equity funds. For that reason, they have traditionally been the domain of hedge funds or specialized credit-fund sponsors.

Holding both equity and debt positions creates conflicts of interest for the sponsor. In highly leveraged businesses, which is where these funds invest, debtholders’ interests may diverge significantly from those of the equityholders.107 This makes it all the more remarkable that private equity sponsors may manage funds that are simultaneously invested in the equity and the debt of the same portfolio company.108 In such cases, investors in both the equity fund and the credit fund will worry that the interests of the sponsor may cause it to favor the other. Moreover, even if the equity and debt funds operate independently and do not share information, the funds’ common affiliation imposes risks on both sets of investors (such as negative treatment in bankruptcy) that they may not have priced in.109

Beyond the obvious concerns for the respective fund investors, however, lies a governance concern for the portfolio company itself. Ex ante, common ownership of equity and debt from the outset reduces agency costs from the classic shareholder-creditor conflict and could therefore increase firm value.110 The result may be different, however, if the common ownership arises ex post. If a sponsor’s fund acquires the debt of a portfolio company already owned by another of its funds, the agency costs have already been priced in and addressed in the debt covenants. Common ownership at this stage may simply create uncertainty about the portfolio company’s governance. While self-interested

105 See Tuch, supra note 23, at 354-55; Vandeveld, supra note 25.
106 Tuch, supra note 23, at 356-57.
108 See Birdthistle & Henderson, supra note 99, at 57.
109 In particular, the debt fund investors should be concerned about equitable subordination or debt recharacterization—the possibility that the bankruptcy court will choose to treat the company debt held by the fund as equity, as a result of actions taken by the sponsor whose fund also holds the company’s stock. See James W. Wilton & William A. McGee, The Past and Future of Debt Recharacterization, 74 BUS. LAW. 91, 91-93 (2018).
110 See Wei Jiang, Kai Li & Pei Shao, When Shareholders Are Creditors: Effects of the Simultaneous Holding of Equity and Debt by Non-Commercial Banking Institutions, 23 REV. FIN. STUD. 3595, 3595 (2010) (finding evidence that loan spreads are relatively lower in firms with non-bank investors that hold both equity and debt positions).
investors are a given in corporate finance, conflicted investors are more problematic, particularly when they have control. Conflicts create uncertainty as to how the investor will ultimately behave and make it less likely that the behavior will be value increasing for the company.

Even within the LBO strategy, the recent proliferation of funds entails intense competition for investment opportunities. This exacerbates existing conflicts of interest for any private equity firm that is simultaneously managing two or more LBO funds. Traditionally, private equity firms negotiate with their investors for the right to launch a new fund (a “successor fund”) with the same investment strategy as the firm’s existing fund, once the latter has succeeded in deploying most of its capital. But the extraordinarily favorable fundraising climate for private equity has meant that private equity firms are successfully compressing the time between funds from more than five years to less than three and a half. This has several implications. Necessarily, a greater proportion of managers’ time is being taken up by fundraising, as opposed to investment analysis, execution, and monitoring. Further, the conflicts that have long existed between successor and predecessor funds are made more severe. Difficult questions that arise include how a sponsor should allocate investment opportunities among its various funds and whether the sponsor should be able to cause its funds to buy and sell investments from one another.

Not surprisingly, managing such conflicts now takes up a non-negligible amount of both the principals’ and investors’ time. The fund disclosures and provisions dealing with conflicted transactions have increased dramatically in length. Yet even where the potential for such conflicts is extensively disclosed, there will always remain some uncertainty on the investor side as to how severe they will be in practice and how well the private equity firm will navigate them. Investors in an LBO fund may not truly be prepared for the

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112 See BAIN & CO., supra note 16, at 19 (“A look at the 20 largest buyout firms globally shows that the gap between closing one fund and starting another has compressed to 40 months, from 62 months five years ago.”).


possibility that the sponsor will take a position effectively adverse to theirs. The recent enforcement actions by the SEC targeting conflicts of interest in private equity funds suggest that even the most sophisticated private equity investors can indeed be caught off guard by their sponsors’ behavior.117

Conflicts of interest are not bad per se. One would be hard-pressed to form an investment fund without them.118 Private equity has lived with conflicts of interest between the sponsor and fund investors from the beginning, as a result of how the sponsor is compensated for advising the fund.119 These conflicts have long been identified and managed, with varying success. Presumably, investors view them as a necessary and acceptable tradeoff for the potential to earn high returns.

What, then, distinguishes the new crop of conflicts created by private equity’s shifting business model? First, they may significantly exacerbate private equity’s existing conflicts, in today’s highly competitive environment. Second, they are largely avoidable. Unlike the original conflicts of interest from the private equity compensation model, these conflicts reflect the sponsor’s own decision to expand into different strategies and asset classes and to fundraise more frequently. That decision in turn appears to benefit the sponsor more than investors.

In the mutual fund context, the standard practice of having the fund group manage a large number of different funds is justified by economies of scale: for example, it allows the significant regulatory and compliance costs to be spread across funds.120 Yet the argument for economies of scale is far less compelling in the private equity world, which faces dramatically less regulation. As such, it is not immediately clear why a LBO fund and a credit fund managed by the same sponsor would be preferable for investors than two unaffiliated, specialized sponsors. Moreover, the resulting conflicts are much harder for investors to manage in the private equity world, because there is little direct regulation of such conflicts, and because investors have very limited exit rights.121 Instead, investors must rely almost exclusively on contract. Yet contracting around burgeoning, ever-changing conflicts of interest is a difficult and costly exercise.122


118 See generally Morley, supra note 38.

119 See Ludovic Phalippou, Beware of Venturing into Private Equity, 23 J. ECON. PERSP. 147, 162-64 (2009) (describing major conflicts of interest created by private equity’s compensation scheme, and their potential effect of firm value and investor returns).

120 See Morley, supra note 38, at 1261 (arguing that investment adviser conflicts of interest may reflect efficiency-enhancing economies of scale from offering multiple funds).

121 See id. at 1267.

122 See William W. Clayton, The Private Equity Negotiation Myth, 37 YALE J. ON REG. (forthcoming) (arguing that terms of private equity limited partnership agreements are unlikely to be efficiently negotiated, given that large investors routinely negotiate separate terms in side letters).
The advantage of private equity has always been its single-minded pursuit of investor returns. But it is not always clear today which of their investors private equity sponsors are working for. In fact, we have seen all of this before with investment banks. For M&A advisory work, for example, boutique advisors have been gaining market share from the major investment banks as clients seek to avoid Wall Street’s myriad conflicts of interest. Will the same eventually prove true of the major private equity sponsors? Will investors tire of trying to predict which of the firms’ competing loyalties will prevail in any instance? In the meantime, we are left with considerable uncertainty as to how private equity conflicts affect the behavior and value of its portfolio companies.

B. Organizational Complexity

Expansion into other asset classes is not the only driver of private equity’s accelerating conflicts and complexity. Most private equity firms today are now significantly bigger organizations, as a result not only of venturing into other asset classes and jurisdictions, but also of regulatory change and investor demands. Until recently, private equity firms had a reputation for being leanly staffed. Not only did this allow for more profits per investment professional, it also ensured that the interests of each such investment professional would be closely aligned with those of the private equity firm as a whole.

Today’s private equity firms often have a considerably larger workforce, and one that is increasingly composed of non-investment professionals, in areas such as marketing, legal, compliance, investor relations, government relations, and human resources. Following Dodd-Frank, virtually all private equity firms other than the very smallest are required to register as investment advisers under


124 Private equity sponsors are no longer simply the U.S.- and U.K.-based going-private specialists of the late 1980s. With Warburg Pincus as the possible exception that proves the rule, the largest private equity shops have created specialized subdivisions and have raised multiple concurrent funds in multiple countries, aimed at varying markets like Asian real estate and mezzanine debt. Michael J. de la Merced & Peter Lattman, Warburg Stays in the Fray, but off the Public Market, N.Y. TIMES: DEALBOOK (Aug. 17, 2011, 9:07 PM), https://dealbook.nytimes.com/2011/08/17/warburg-stays-in-fray-but-off-public-market/.

125 See Jensen, supra note 2, at 70.

the Investment Advisers Act of 1940.\textsuperscript{127} While the resulting regulatory burdens on private equity firms are light compared to those for mutual fund advisers,\textsuperscript{128} they are not negligible, and they entail greater staffing needs.\textsuperscript{129} Accordingly, major private equity firms today look less like the small, scrappy teams of yore than like the large mutual fund advisers and investment banks.

This pronounced increase in size and scope necessarily introduces some divergence between the interests of the individual investment principals that make up the private equity firm and those of the private equity firm itself. This potentially poses problems for sponsors seeking to maintain a reputation for good behavior towards their investors, creditors, and counterparties, such as by avoiding conflicts or not exploiting them to the investors’ detriment.\textsuperscript{130} As discussed, even the original private equity model involves inherent conflicts of interest, but it is these conflicts that make a sponsor’s reputational capital particularly valuable. Yet the recent growth in headcount creates the potential for misaligned incentives internally, and therefore may make it harder for sponsors to maintain their hard-earned reputations. This should be especially true of the private equity firms that are themselves now public companies, such as Apollo, Blackstone, Carlyle, and KKR.\textsuperscript{131} As with the investment banks, the shift from being a private firm owned by its principals to a public company should alter both organizational and individual behavior over time.\textsuperscript{132} While this is likely to lead to a continued emphasis on profits for the sponsor, there may be


\textsuperscript{130} For a private equity sponsor, or any organization for that matter, acquiring and maintaining reputational capital requires frequently forgoing short-term gain from “bad” behavior, on the theory that having a good reputation will lead to greater gain in the long run. However, the more the interests of the individuals making up the organization diverge from the interests of the organization itself, the more difficult it will be for the organization to maintain its reputation. See John C. Coffee, Jr., Understanding Enron: “It’s About the Gatekeepers, Stupid,” 57 BUS. LAW. 1403, 1405 (2002).


less agreement internally as to the means by which to achieve them and the importance of the firm’s long-run reputational capital.133

C. Contractual Complexity and Bespoke Arrangements

A further challenge for the private equity industry is the rapid increase in the complexity of its contracts and arrangements with investors. Some of this, as we have seen, results from increasing conflicts among the sponsors’ own funds. Some results from tailoring to investor requests in the more competitive environment. Growing dissatisfaction with the “two and twenty” compensation scheme—which awards two percent per annum of the fund’s commitments and a twenty percent share of all investment profits to the private equity manager—has driven investors to alter their arrangements with private equity firms.134 Rather than reduce the rates charged by their funds (to “one and fifteen,” for example), which would apply to their investors across the board, many firms have instead begun providing different economic and other arrangements to different investors.135 Thus, investors in the fund with more bargaining power than the average investor negotiate for special arrangements in the form of side letters, opportunities to co-invest in portfolio investments directly alongside the fund, or even separate accounts (management of their capital entirely outside of a fund structure).136

The complexity of these arrangements, and the time and resources needed to negotiate and comply with them on an ongoing basis, are significant.137 Of course, we should expect that in agreeing to such arrangements, each private equity firm balances the costs and benefits of doing so. Yet now that it has become standard practice for large investors to obtain tailored arrangements and contracts, it is increasingly difficult for any individual sponsor to push back. The market has only moved in one direction, namely toward greater individualization

133 See Cem Demiroglu & Christopher M. James, The Role of Private Equity Group Reputation in LBO Financing, 96 J. FIN. ECON. 306, 306 (2010) (showing that more reputable private equity sponsors benefit from more favorable debt financing for their portfolio companies).

134 For a description of this compensation scheme, see Fleischer, supra note 28, at 8.

135 For example, anchor investors are able to negotiate for reductions in the management fee percentage. See Ingo Stoff & Reiner Braun, The Evolution of Private Equity Fund Terms Beyond 2 and 20, 26 J. APPLIED CORP. FIN. 65, 71-72 (2014).


and complexity. While individual investors have an incentive to negotiate for separate rights from the sponsor, from the perspective of the industry as a whole, this is unlikely to be efficient. This matters, because the complexity of a private equity sponsor’s internal organization and of its external contractual commitments to investors makes it less nimble—not only less focused on the investment side of the business, perhaps, but also more constrained in its investment options to begin with. For example, a side letter provision requiring the fund to excuse a particular investor before making investments in certain industries could result in the fund foregoing such investments entirely, even where there are profits to be made. Thus, once again, we have less clarity today as to whether sponsors’ treatment of any given portfolio company will be value-maximizing.

D. Financial Games

Private equity sponsors’ incentives to generate returns of any kind and from any source are generally viewed by investors as a positive feature of the industry. Yet in a highly competitive environment, the pressure to show returns early and often can ironically lead to behavior that is either neutral or bad for investors and portfolio companies. Given private equity managers’ particular skillset, this behavior often involves clever games with financing.

Nowhere is this more evident than in the effort and resources devoted to managing their funds’ internal rate of return (“IRR”). A fund’s IRR measures the return on the capital that the fund invests in portfolio companies and other investments. Importantly, for any given payoff from an investment, the IRR figure decreases the longer the fund’s capital has been invested before the payoff occurred. For example, assume that a fund invests one hundred million dollars of its own capital in a portfolio company, and later nets one hundred and fifty million dollars from selling it. The IRR in this case is significantly higher if the company was sold one year after the fund acquired it, as opposed to five years (all else being equal).

Predictably, then, private equity firms have realized that they can increase their IRR in one of two ways. First, of course, they can produce higher returns. Second, they can game the IRR calculation by realizing returns faster, or,

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139 But see Clayton, supra note 136, at 254 (arguing that individually tailored arrangements for private equity investors is value enhancing).

140 Sponsors’ desire to minimize their tax burden may also lead to behavior that is suboptimal for investors and portfolio companies. See Gregg D. Polsky, A Compendium of Private Equity Tax Games, 146 Tax Notes 615, 615 (2015).


142 Id. at 8-9.
equivalently, by keeping investors’ money for a shorter amount of time. Now that competition has made it challenging to produce high returns, private equity firms have had to resort to the second option of shortening the holding period for investors’ money. A now common way of achieving this is for private equity funds to obtain capital call facilities from banks. Rather than call investor capital at the time the fund plans to make an investment, the fund may instead draw down on its capital call facility and use the borrowed funds to make the investment instead. Eventually, the fund will call capital from investors and use this to repay the loan from the bank. Borrowing to fund capital calls increases the fund’s IRR by allowing the fund to shorten the period in which it holds its own investors’ capital, but because the fund must pay interest on the loan facility, it is not necessarily beneficial to investors.

Capital call facilities originally were justified as very short-term borrowings to allow private equity funds to make investments on short notice, given that calling capital from investors typically requires fifteen days’ advance notice. Yet funds are now borrowing under these facilities for months at a time, funding even large investments without their own investors’ capital. In principal, if the fund can avoid calling capital until just before the investment is sold, the fund’s resulting IRR will be infinite. Accordingly, empirical studies have found that private equity funds’ IRRs tend to have an upward bias.

Why is managing IRR so important to private equity sponsors? First, IRR is the single most commonly-used measure of a fund’s performance, making it a crucial component of the private equity firm’s marketing. For example, the private placement memorandum for a new fund typically reports the IRR of the sponsor’s predecessor funds in the same strategy. Second, the private equity sponsor’s compensation depends on its funds’ IRRs. Private equity funds typically distribute profits from their investments according to a specified

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147 See id.

148 See Phalippou & Gottschalg, supra note 17, at 1767; Phalippou, supra note 143 (manuscript at 5).

priority (the “waterfall”). The waterfall generally provides that limited partners must recover their capital first, as well as an eight percent preferred return on their invested capital, before the private equity manager may receive any share of the profits. The preferred return is akin to an IRR calculation, however. Thus, the more the firm boosts IRR, the sooner the private equity manager can claim a share of the fund’s profits.

At worst, these sorts of financial games are a means for private equity sponsors to deceive their own investors and potential investors. At best, they are distractions from a fund’s core investment strategy. As such, they are perhaps emblematic of private equity’s recent turn away from the traditional LBO strategy of improving firm governance and operations, towards alternate means of showing returns.

CONCLUSION

Is private equity still special? Recent empirical studies call into question whether private equity’s returns remain exceptional today among the major asset classes. Yet we should also ask whether the means by which private equity generates those returns remains the same today as during prior decades. This Article argues that a combination of factors is pushing private equity away from its original contribution of improving firms’ governance and operations, towards a scattershot of tactics to boost returns. While reforming and restructuring companies is what brought private equity fame, the industry has since moved on to other things. To be clear, private equity is not going anywhere—it will remain influential and a powerful draw for capital for the foreseeable future. Yet its influence will be felt in areas other than corporate governance.

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151 Id. at 1451-52.
152 See Dean Altshuler & Roy Schneiderman, Overpayment of Manager Incentive Fees—When Preferred Returns and IRR Hurdles Differ, 17 J. REAL EST. PORTFOLIO MGMT. 181, 181 (2011) (finding that there is no difference between preferred returns and IRR hurdles in the majority of portfolios).