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Private Equity

The Strategic Secret of Private Equity

by Felix Barber and Michael Goold

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Summary. The huge sums that private equity firms make on their investments evoke admiration and envy. Typically, these returns are attributed to the firms' aggressive use of debt, concentration on cash flow and margins, freedom from public company regulations, and hefty incentives for operating managers. But the fundamental reason for private equity's success is the strategy of buying to sell—one rarely employed by public companies, which, in pursuit of synergies, usually buy to keep.

The chief advantage of buying to sell is simple but often overlooked, explain Barber and Goold, directors of the Ashridge Strategic Management Centre. Private equity's sweet spot is acquisitions that have been undermanaged or undervalued, where there's a onetime opportunity to increase a business's value. Once that gain has been realized, private equity firms sell for a maximum return. A corporate acquirer, in contrast, will dilute its return by hanging on to the business after the growth in value tapers off.

Public companies that compete in this space can offer investors better returns than private equity firms do. (After all, a public company wouldn't deduct the 30% that funds take out of gross profits.) Corporations have two options: (1) to copy private equity's model, as investment companies Wendel and Eurazeo have done with dramatic success, or (2) to take a flexible approach, holding businesses for as long as they can add value as owners. The latter would give companies an advantage over funds, which must liquidate within a preset time—potentially leaving money on the table.

Both options present public companies with challenges, including U.S. capital-gains taxes and a dearth of investment management skills. But the greatest barrier may be public companies' aversion to exiting a healthy business and their inability to see it the way private equity firms do—as the culmination of a successful transformation, not a strategic error. **close**

Private equity. The very term continues to evoke admiration, envy, and—in the hearts of many public company CEOs—fear. In recent years, private equity firms have pocketed huge—and controversial—sums, while stalking ever larger acquisition targets. Indeed, the global value of private equity buyouts bigger than $1 billion grew from $28 billion in 2000 to $502 billion in 2006, according to Dealogic, a firm that tracks acquisitions. Despite the private equity environment's becoming more challenging amid rising interest rates and greater government scrutiny, that figure reached $501 billion in just the first half of 2007.

Private equity firms' reputation for dramatically increasing the value of their investments has helped fuel this growth. Their ability to achieve high returns is typically attributed to a number of factors: high-powered incentives both for private equity portfolio managers and for the operating managers of businesses in the portfolio; the aggressive use of debt, which provides financing and tax advantages; a determined focus on cash flow and margin improvement; and freedom from restrictive public company regulations.

But the fundamental reason behind private equity's growth and high rates of return is something that has received little attention, perhaps because it's so obvious: the firms' standard practice of buying businesses and then, after steering them through a transition of rapid performance improvement, selling them. That strategy, which embodies a combination of business and investment-portfolio management, is at the core of private equity's success.

Public companies—which invariably acquire businesses with the intention of holding on to them and integrating them into their operations—can profitably learn or borrow from this buy-to-sell approach. To do so, they first need to understand just how private equity firms employ it so effectively.

The Private Equity Sweet Spot

Clearly, buying to sell can't be an all-purpose strategy for public companies to adopt. It doesn't make sense when an acquired business will benefit from important synergies with the buyer's existing portfolio of businesses. It certainly isn't the way for a company to profit from an acquisition whose main appeal is its prospects for long-term organic growth.

However, as private equity firms have shown, the strategy is ideally suited when, in order to realize a onetime, short- to medium-term value-creation opportunity, buyers must take outright ownership and control. Such an opportunity most often arises when a business hasn't been aggressively managed and so is underperforming. It can also be found with businesses that are undervalued because their potential isn't readily apparent. In those cases, once the changes necessary to achieve the uplift in value have been made—usually over a period of two to six years—it makes sense for the owner to sell the business and move on to new opportunities. (In fact, private equity firms are obligated to eventually dispose of the businesses; see the sidebar "How Private Equity Works: A Primer.")

How Private Equity Works: A Primer

To clarify how fundamental the buy-to-sell approach is to private equity's success, it's worth reviewing the basics of private equity ownership.

Private equity firms raise funds from institutions and wealthy individuals and then invest that money in buying and selling businesses. After raising a specified amount, a fund will close to new investors; each fund is liquidated, selling all its businesses, within a preset time frame, usually no more than 10 years. A firm's track record on previous funds drives its ability to raise money for future funds.

Private equity firms accept some constraints on their use of investors' money. A fund management contract may limit, for example, the size of any single business investment. Once money is committed, however, investors—in contrast to shareholders in a public company—have almost no control over management. Although most firms have an investor advisory council, it has far fewer powers than a public company's board of directors.

The CEOs of the businesses in a private equity portfolio are not members of a private equity firm's management. Instead, private equity firms exercise control over portfolio companies through their representation on the companies' boards of directors. Typically, private equity firms ask the CEO and other top operating managers of a business in their portfolios to personally invest in it as a way to ensure their commitment and motivation. In return, the operating managers may receive large rewards linked to profits when the business is sold. In accordance with this model, operating managers in portfolio businesses usually have greater autonomy than unit managers in a public company. Although private equity firms are beginning to develop operating skills of their own and thus are now more likely to take an active role in the management of an acquired business, the traditional model in which private equity owners provide advice but don't intervene directly in day-to-day operations still prevails.

With large buyouts, private equity funds typically charge investors a fee of about 1.5% to 2% of assets under management, plus, subject to achieving a minimum rate of return for investors, 20% of all fund profits. Fund profits are mostly realized via capital gains on the sale of portfolio businesses.

Because financing acquisitions with high levels of debt improves returns and covers private equity firms' high management fees, buyout funds seek out acquisitions for which high debt makes sense. To ensure they can pay financing costs, they look for stable cash flows, limited capital investment requirements, at least modest future growth, and, above all, the opportunity to enhance performance in the short to medium term.

Private equity firms and the funds they manage are typically structured as private partnerships. In some

The benefits of buying to sell in such situations are plain—though, again, often overlooked. Consider an acquisition that quickly increases in value—generating an annual investor return of, say, 25% a year for the first three years—but subsequently earns a more modest if still healthy return of, say, 12% a year. A private equity firm that, following a buy-to-sell strategy, sells it after three years will garner a 25% annual return. A diversified public company that achieves identical operational performance with the acquired business—but, as is typical, has bought it as a long-term investment—will earn a return that gets closer to 12% the longer it owns the business. For the public company, holding on to the business once the value-creating changes have been made dilutes the final return.

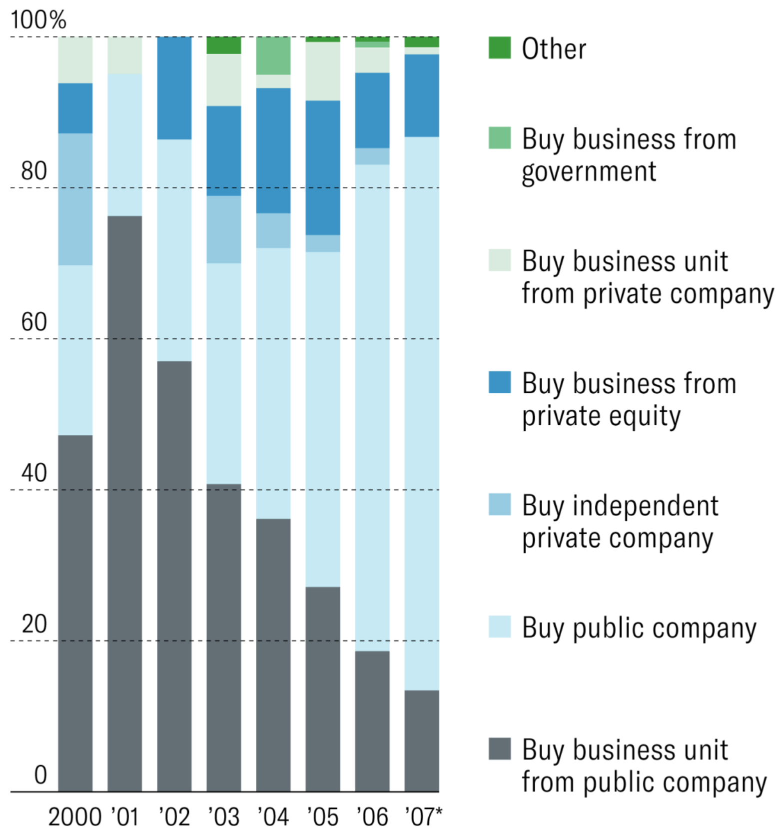
In the early years of the current buyout boom, private equity firms prospered mainly by acquiring the noncore business units of large public companies. Under their previous owners, those businesses had often suffered from neglect, unsuitable performance targets, or other constraints. Even if well managed, such businesses may have lacked an independent track record because the parent company had integrated their operations with those of other units, making the businesses hard to value. Sales by public companies of unwanted business units were the most important category of large private equity buyouts until 2004, according to Dealogic, and the leading firms' widely admired history of high investment returns comes largely from acquisitions of this type.

More recently, private equity firms—aiming for greater growth—have shifted their attention to the acquisition of entire public companies. (See the exhibit "Private Equity's New Focus.") This has created new challenges for private equity firms. In public companies, easily realized improvements in performance often have already been achieved through better corporate governance or the activism of hedge funds. For example, a hedge fund with a significant stake in a public company can, without having to buy the company outright, pressure the board into making valuable changes such as selling unnecessary assets or spinning off a noncore unit. If a public company needs to be taken private to improve its performance, the necessary changes are likely to test a private equity firm's implementation skills far more than the acquisition of a business unit would. When KKR and GS Capital Partners, the private equity arm of Goldman Sachs, acquired the Wincor Nixdorf unit from Siemens in 1999, they were able to work with the incumbent management and follow its plan to grow revenues and margins. In contrast, since taking Toys "R" Us private in 2005, KKR, Bain Capital, and Vornado Realty Trust have had to replace the entire top management team and develop a whole new strategy for the business.

Private Equity's New Focus

Over time, private equity firms have shifted from buying business units of public companies to taking entire public companies private.

Percent of total private equity deal value
(deals worth $1 billion or more)



*First half of year
Source: Dealogic

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Many also predict that financing large buyouts will become much more difficult, at least in the short term, if there is a cyclical rise in interest rates and cheap debt dries up. And it may become harder for firms to cash out of their investments by taking them public; given the current high volume of buyouts, the number of large IPOs could strain the stock markets' ability to absorb new issues in a few years.

Even if the current private equity investment wave recedes, though, the distinct advantages of the buy-to-sell approach—and the lessons it offers public companies—will remain. For one thing, because all businesses in a private equity portfolio will soon be sold, they remain in the spotlight and under constant pressure to perform. In contrast, a business unit that has been part of a public company's portfolio for some time and has performed adequately, if not spectacularly, generally doesn't get priority attention from senior management. In addition, because every investment made by a private equity fund in a business must be liquidated within the life of the fund, it is possible to precisely measure cash returns on those investments. That makes it easy to create incentives for fund managers and for the executives running the businesses that are directly linked to the cash value received by fund investors. That is not the case with business unit managers or even for corporate managers in a public company.

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Furthermore, because private equity firms buy only to sell, they are not seduced by the often alluring possibility of finding ways to share costs, capabilities, or customers among their businesses. Their management is lean and focused, and avoids the waste of time and money that corporate centers, when responsible for a number of loosely related businesses and wishing to justify their retention in the portfolio, often incur in a vain quest for synergy.

Finally, the relatively rapid turnover of businesses required by the limited life of a fund means that private equity firms gain know-how fast. Permira, one of the largest and most successful European private equity funds, made more than 30 substantial acquisitions and more than 20 disposals of independent businesses from 2001 to 2006. Few public companies develop this depth of experience in buying, transforming, and selling.

What Public Companies Can Do

As private equity has gone from strength to strength, public companies have shifted their attention away from value-creation acquisitions of the sort private equity makes. They have concentrated instead on synergistic acquisitions. Conglomerates that buy unrelated businesses with potential for significant performance improvement, as ITT and Hanson did, have fallen out of fashion. As a result, private equity firms have faced few rivals for acquisitions in their sweet spot. Given the success of private equity, it is time for public companies to consider whether they might compete more directly in this space.

We see two options. The first is to adopt the buy-to-sell model. The second is to take a more flexible approach to the ownership of businesses, in which a willingness to hold on to an acquisition for the long term is balanced by a commitment to sell as soon as corporate management feels that it can no longer add further value.

Buy to sell. Companies wishing to try this approach in its pure form face some significant barriers. One is the challenge of overhauling a corporate culture that has a buy-to-keep strategy embedded in it. That requires a company not only to shed deeply held beliefs about the integrity of a corporate portfolio but also to develop new resources and perhaps even dramatically change its skills and structures.

In the United States a tax barrier also exists. Whereas private equity funds, organized as private partnerships, pay no corporate tax on capital gains from sales of businesses, public companies are taxed on such gains at the normal corporate rate. This corporate tax difference is not offset by lower personal taxes for public company investors. Higher taxes greatly reduce the attractiveness of public companies as a vehicle for buying businesses and selling them after increasing their value. Public companies in Europe once faced a similar tax barrier, but in roughly the past five years, it has been eliminated in most European countries. This much improves European public companies' tax position for buying to sell. (Note that two tax issues have been the subject of public scrutiny in the United States. The first—whether *publicly traded* private equity management firms should be treated like private partnerships or like public companies for tax purposes—is closely related to the issue we raise. The second—whether the share of profits that private equity firms' partners earn on selling businesses in funds under their management should be taxed at the low rate for personal capital gains or the higher rate for ordinary personal income—is quite distinct.)

Conglomerates that acquire unrelated businesses with potential for significant improvement have fallen out of fashion. As a result, private equity firms have faced few rivals in their sweet spot.

Despite the hurdles, some public companies have in fact successfully developed a buy-to-sell business model. Indeed, two longtime players in mid-market buyouts (those valued between $30 million and $1 billion) are public companies: American Capital Strategies, which had a recent market capitalization of about $7 billion, and the UK-based 3i, whose market cap is about $10 billion. Both companies found ways to circumvent the corporate capital gains tax (the UK eliminated the tax only in 2002) by adopting unusual organizational structures—a "business development company" in the case of American Capital; an "investment trust" in the case of 3i. However, those structures place legal and regulatory restrictions on the firms' operations; for instance, there are limitations on business development companies' ability to acquire public companies and the amount of debt they may use. Those restrictions make such structures unattractive as vehicles for competing with private equity, at least for large buyouts in the United States.

With the removal of the tax disincentives across Europe, a few new publicly quoted buyout players have emerged. The largest are two French companies, Wendel and Eurazeo. Both have achieved strong returns on their buyout investments. Eurazeo, for example, has achieved an average internal rate of return of 53% on Terreal, Eutelsat, and Fraikin, its three large buyout exits over the past five years. (In the United States, where private companies can elect, like private partnerships, not to be subject to corporate tax, Platinum Equity has become one of the fastest-growing private companies in the country by competing to buy out subsidiaries of public companies.)

The emergence of public companies competing with private equity in the market to buy, transform, and sell businesses could benefit investors substantially. Private equity funds are illiquid and are risky because of their high use of debt; furthermore, once investors have turned their money over to the fund, they have no say in how it's managed. In compensation for these terms, investors should expect a high rate of return. However, though some private equity firms have achieved excellent returns for their investors, over the long term the average net return fund investors have made on U.S. buyouts is about the same as the overall return for the stock market.

Private equity fund managers, meanwhile, have earned extremely attractive rewards, with little up-front investment. As compensation for taking the initiative in raising money, managing investments, and marketing their benefits, they have structured agreements so that a large portion of the gross returns —around 30%, after adding management and other fees—flows to them. And that figure doesn't take into account any returns made on their personal investments in the funds they manage. Public companies pursuing a buy-to-sell strategy, which are traded daily on the stock market and answerable to stockholders, might provide a better deal for investors.

From where might a significant number of publicly traded competitors to private equity emerge? Even if they appreciate the attractions of the private equity strategy in principle, few of today's large public industrial or service companies are likely to adopt it. Their investors would be wary. Also, few corporate managers would slip easily into a more investment-management-oriented role. Private equity partners typically are former investment bankers and like to trade. Most top corporate managers are former business unit heads and like to manage.

Public financial firms, however, may find it easier to follow a buy-to-sell strategy. More investment companies may convert to a private equity management style, as Wendel and Eurazeo did. More private equity firms may decide, as U.S.-based Ripplewood did with the initial public offering of RHJ International on the Brussels stock exchange, to float an entire investment portfolio on the public markets. More experienced investment banks may follow the lead of Macquarie Bank, which created Macquarie

Capital Alliance Group, a company traded on the Australian Securities Exchange that focuses on buy-to-sell opportunities. In addition, some experienced private equity managers may decide to raise public money for a buyout fund through an IPO. (These examples are to be distinguished from the private equity firm Blackstone's initial public offering of the *firm that manages* the Blackstone funds, but not the funds themselves.)

Flexible ownership. A strategy of flexible ownership could have wider appeal to large industrial and service companies than buying to sell. Under such an approach, a company holds on to businesses for as long as it can add significant value by improving their performance and fueling growth. The company is equally willing to dispose of those businesses once that is no longer clearly the case. A decision to sell or spin off a business is viewed as the culmination of a successful transformation, not the result of some previous strategic error. At the same time, the company is free to hold on to an acquired business, giving it a potential advantage over private equity firms, which sometimes must forgo rewards they'd realize by hanging on to investments over a longer period.

Flexible ownership can be expected to appeal the most to companies with a portfolio of businesses that don't share many customers or processes. Take General Electric. The company has demonstrated over the years that corporate management can indeed add value to a diversified set of businesses. GE's corporate center helps build general management skills (such as cost discipline and quality focus) across its businesses and ensures that broad trends (such as offshoring to India and the addition of service offerings in manufacturing businesses) are effectively exploited by them all. Despite occasional calls for GE to break itself up, the company's management oversight has been able to create and sustain high margins across its portfolio, which suggests that limiting itself to synergistic acquisitions would be a mistake.

> **A decision to sell or spin off a business is viewed as the culmination of a successful transformation, not the result of a strategic error.**

Indeed, with its fabled management skills, GE is probably better equipped to correct operational underperformance than private equity firms are.

To realize the benefits of flexible ownership for its investors, though, GE would need to be vigilant about the risk of keeping businesses after corporate management could no longer contribute any substantial value. GE is famous for the concept of cutting the bottom 10% of managers every year. To ensure aggressive investment management, the company could, perhaps with less controversy, initiate a requirement to sell every year the 10% of businesses with the least potential to add value.

GE would of course have to pay corporate capital gains taxes on frequent business disposals. We would argue that the tax constraints that discriminate against U.S. public companies in favor of private equity funds and private companies should be eliminated. Nevertheless, even in the current U.S. tax environment, there are ways for public companies to lighten this burden. For example, spinoffs, in which the owners of the parent company receive equity stakes in a newly independent entity, are not subject to the same constraints; after a spinoff, individual shareholders can sell stock in the new enterprise with no corporate capital gains tax payable.

We have not found any large public companies in the industrial or service sector that explicitly pursue flexible ownership as a way to compete in the private equity sweet spot. Although many companies go through periods of actively selling businesses, the purpose is usually to make an overly diversified portfolio more focused and synergistic, not to realize value from successfully completed performance enhancements. Even the acquisitive conglomerates, such as ITT and Hanson, that successfully targeted performance improvement opportunities ultimately weren't willing enough to sell or spin off businesses once they could no longer increase their value—and thus found it difficult to sustain earnings growth. But given the success of private equity's model, companies need to rethink the traditional taboos about selling businesses.

Choosing and Executing a Portfolio Strategy

As we have seen, competing with private equity offers public companies a substantial opportunity, but it isn't easy to capitalize on. Managers need skills in investing (both buying and selling) and in improving operating management. The challenge is similar to that of a corporate restructuring—except that it must be repeated again and again. There is no return to business as usual after the draining work of a transformation is completed.

Competing with private equity as a way to create shareholder value will make sense primarily for companies that own a portfolio of businesses that aren't closely linked. (For more on the range of investment approaches that funds and corporate buyers take, see the sidebar "Mapping Potential Portfolio Strategies.") In determining whether it's a good move for your company, you need to ask yourself some tough questions:

Can you spot and correctly value businesses with improvement opportunities? For every deal a private equity firm closes, it may proactively screen dozens of potential targets. Many firms devote more capacity to this than to anything else. Private equity managers come from investment banking or strategy consulting, and often have line business experience as well. They use their extensive networks of business and financial connections, including potential bidding partners, to find new deals. Their skill at predicting cash flows makes it possible for them to work with high leverage but acceptable risk. A public company adopting a buy-to-sell strategy in at least part of its business portfolio needs to assess its capabilities in these areas and, if they are lacking, determine whether they could be acquired or developed.

Do you have the skills and the experience to turn a poorly performing business into a star? Private equity firms typically excel at putting strong, highly motivated executive teams together. Sometimes that simply involves giving current managers better performance incentives and more autonomy than they have known under previous ownership. It may also entail hiring management talent from the competition. Or it may mean working with a stable of "serial entrepreneurs," who, although not on the firm's staff, have successfully worked more than once with the firm on buyout assignments.

Mapping Potential Portfolio Strategies

Both public companies and investment funds manage portfolios of equity investments, but they have very different approaches to deciding which businesses belong in them and why. Public companies can learn something from considering the broad array of common equity investment strategies available.

A portfolio manager can take one of three approaches to creating value: simply make smart investments; invest in businesses and then influence their managers to produce better results; or invest and influence while looking to build synergies among portfolio businesses. At the same time, the nature of a portfolio's holdings will be defined by whether the owner or investor acquires them with the intention of selling them in the short or medium term (the strategy of most investment funds) or keeping them for the long term (the strategy of most public companies).

The search for synergies that will enhance operating performance across portfolio businesses plays a critical role in many public companies' strategies, and in fact, often drives the acquisition agenda. Procter & Gamble is an example of a successful company that acquires businesses that have strong synergies and keeps them for the long term. It would not make sense for P&G to integrate an acquired business into its own process infrastructure—and then suddenly put it on the block for sale.

A few diversified public companies, such as Berkshire Hathaway, seek to create shareholder value merely by making smart investment decisions. Like P&G, Berkshire buys to keep. Unlike P&G, however, it doesn't have to, because its success doesn't depend on the long-term exploitation of synergies. Warren Buffett actually admits in the Berkshire Hathaway owner's manual that buying to keep hurts the company's financial performance. To be good investments, Berkshire's businesses have to beat the market not just for five or 10 years but forever! Even if you are the Sage of Omaha, that is a tall order.

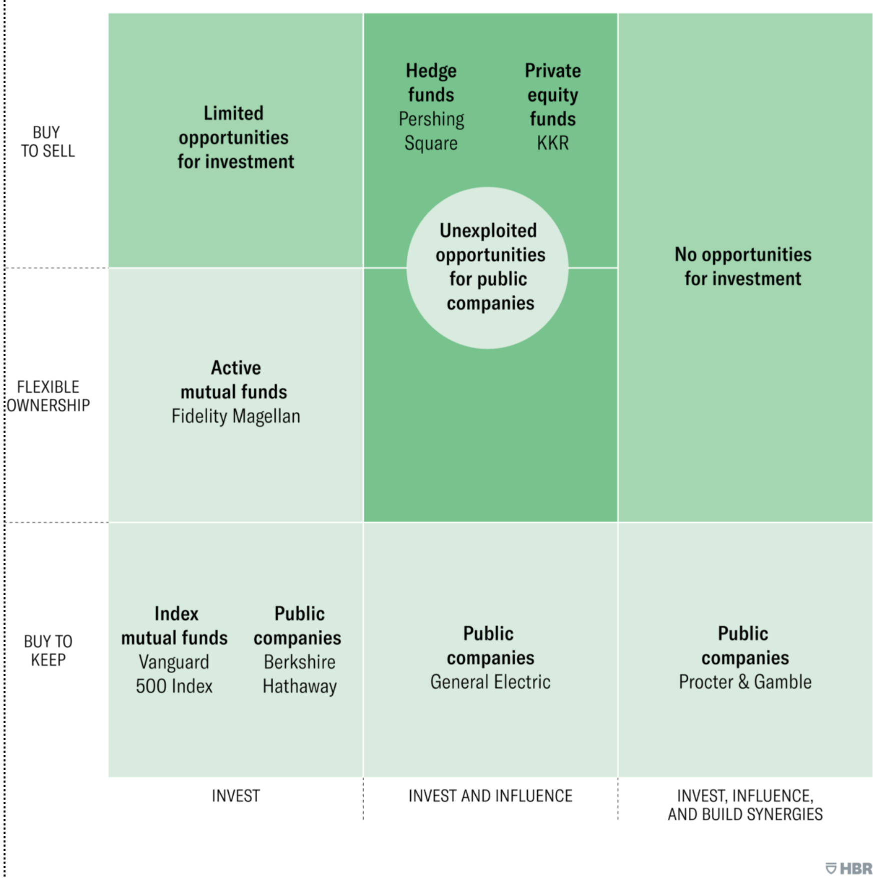
Compare Berkshire Hathaway's strategy with that of investment funds. Index mutual funds, such as the Vanguard 500 Index Fund, buy to keep, but they seek to match the market, not to beat it. Active mutual funds that do seek to beat the market, such as the Fidelity Magellan Fund, adopt a flexible ownership strategy.

Buying with a definite intention to sell is more typical for "event-driven" investors, such as Pershing Square and other hedge funds. They buy shares in companies in which they expect a particular event, such as a merger or a breakup, to create shareholder value, and plan to sell out and take their profits once it occurs. These investors are usually activists, pressuring the company's management to carry out the anticipated event, or are riding on the coattails of activists. After all, if profits depend on a merger or breakup, it's logical to use your influence to trigger it. Perhaps because it's hard to beat the market by investing without influence on management, activist investing is becoming more common.

Because they maintain liquidity for their investors, hedge funds and mutual funds cannot bid to take outright control of public companies or invest in private companies. This is where private equity funds, such as those managed by KKR, which are willing to sacrifice liquidity for investors, have an edge.

Some diversified public companies, like General Electric, focus, as do private equity funds, on making good acquisitions and exerting a positive influence on their management. The important difference is that where private equity funds buy with the intention to sell, diversified public companies typically buy with the intention to keep. If recent history is any indicator—private equity firms are growing while conglomerates have dwindled in number—the private equity funds may have the more successful strategy.

Public companies acquire for the long term but miss opportunities that investors with shorter horizons are seizing.



Good private equity firms also excel at identifying the one or two critical strategic levers that drive improved performance. They are renowned for excellent financial controls and for a relentless focus on enhancing the performance basics: revenue, operating margins, and cash flow. Plus, a governance structure that cuts out a layer of management—private equity partners play the role of both corporate management and the corporate board of directors—allows them to make big decisions fast.

Over the course of many acquisitions, private equity firms build their experience with turnarounds and hone their techniques for improving revenues and margins. A public company needs to assess whether it has a similar track record and skills and, if so, whether key managers can be freed up to take on new transformation challenges.

Note, however, that whereas some private equity firms have operating partners who focus on business performance improvement, most do not have strength and depth in operating management. This could be a trump card for a public company adopting a buy-to-sell strategy and competing with the private equity players.

Can you manage a steady stream of both acquisitions and disposals? Private equity firms know how to build and manage an M&A pipeline. They have a strong grasp of how many targets they need to evaluate for every bid and the probability that a bid will succeed. They have disciplined processes that prevent them from raising bids just to achieve an annual goal for investing in deals.

At least as important, private equity firms are skilled at selling businesses, by finding buyers willing to pay a good price, for financial or strategic reasons, or by launching successful IPOs. In fact, private equity firms develop an exit strategy for each business during the acquisition process. Assumptions about exit price are probably the most important factor in their valuations of targets—and are continually monitored after deals close. A public company needs to assess not only its ability but also its willingness to become an expert at shedding healthy businesses.

If you can comfortably answer yes to those three questions, you next need to consider what kind of portfolio strategy to pursue.

Flexible ownership seems preferable to a strict buy-to-sell strategy in principle because it allows you to make decisions based on up-to-date assessments of what would create the most value. But a flexible ownership strategy always holds the risk of complacency and the temptation to keep businesses too long: A stable corporate portfolio, after all, requires less work. What is more, a strategy of flexible ownership is difficult to communicate with clarity to investors and even your own managers, and may leave them feeling unsure of what the company will do next.

Our expectation is that financial companies are likely to choose a buy-to-sell approach that, with faster churn of the portfolio businesses, depends more on financing and investment expertise than on operating skills. Industrial and service companies are more likely to favor flexible ownership. Companies with a strong anchor shareholder who controls a high percentage of the stock, we believe, may find it easier to communicate a flexible ownership strategy than companies with a broad shareholder base.

Joining the Fray

Private equity's phenomenal growth has given rise to intense public debate. Some complain that private equity essentially is about asset stripping and profiteering, with private equity investors, partners, and managers taking unfair advantage of tax breaks and regulatory loopholes to make unseemly amounts of money from dubious commercial practices. Others defend private equity as a generally superior way of managing businesses.

Our own view is that the success of private equity firms is due primarily to their unique buy-to-sell strategy, which is ideally suited to rejuvenating undermanaged businesses that need a period of time in intensive care. Private equity *has* enjoyed an unfair tax advantage, but this has been primarily because of corporate capital gains taxes, not private equity firms' use of interest payments on debt financing to shield profits from tax. (Public companies, after all, can also finance acquisitions and other investments with borrowed money.) The high rewards enjoyed by private equity partners reflect the value they create—but also investors' somewhat surprising willingness to invest in private equity funds at average rates of return, which, in relation to risk, appear low.

We believe it's time for more public companies to overcome their traditional aversion to selling a business that's doing well and look for opportunities to compete in the private equity sweet spot.

(Such a change would be hastened if the United States and other governments followed the lead of European nations in leveling the tax playing field.) Public companies could then benefit from the opportunities afforded by a buy-to-sell strategy. Investors would benefit, too, as the greater competition in this space would create a more efficient market—one in which private equity partners were no longer so strongly favored over the investors in their funds.

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