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Primer on Private Equity

Private equity firms have grown substantially since the 1980s and now manage more than $6 trillion in assets in the United States. Their presence has affected industries from hospitals to fisheries.

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Private equity is seemingly inescapable. From housing to hospitals and fisheries to fast food, equity investors have acquired a host of businesses in recent decades. Private equity firms control more than $6 trillion in assets in the U.S. But what makes them different from any other type of investor putting their money into a business?

Private equity investors — typified by firms like Bain Capital, Apollo Global Management, TPG, KKR and Blackstone — are different from venture capitalists, who provide a cash infusion to small startups and hope they blossom into the next Facebook. Nor are they stock traders making split-second decisions to buy or sell shares in public companies. Rather, private equity funds aim to take control of a business for a relatively short time, restructure it and resell the company at a profit.

The ways in which private equity goes about this restructuring can raise a number of concerns, over such things as layoffs and furloughs for employees and degraded services for customers. Critics also worry that private equity firms weigh down acquired companies with substantial debt from the money borrowed to finance the purchase.

What Is Private Equity?

Private equity funds are pooled investments that are generally not open to small investors. Private equity firms invest the money they collect on behalf of the fund's investors, usually by taking controlling stakes in companies. The private equity firm then works with company executives to make the businesses — called portfolio companies — more valuable so they can sell them later at a profit.

This is different from, say, an individual investor buying a share of Amazon stock for $135. Purchasing that share gives you an infinitesimal stake in the company and entitles you to any dividend the company may pay out, but your ownership stake isn't large enough to affect the company's decision-making and operations. Private equity funds, by contrast, are not publicly traded securities, and the amount they invest usually involves trying to take a controlling stake in companies.

Private equity funds are generally backed by investments from large institutional investors: pension funds, sovereign wealth funds, endowments and very wealthy individuals. Private equity firms manage these funds, using both investors' contributions and borrowed money.

Like any business, private equity firms want to make money, generating returns for their investors. Fund managers typically spend time conducting extensive research on both companies and industries — called due diligence — before making an investment. They consider multiple factors when deciding to invest. Among them are whether a company operates in an industry that's difficult for other competitors to enter, generates consistent profits (or can become profitable), provides a reliable cash flow so it can pay off debt, has a strong position or brand within its market, has an effective management team, isn't likely to face disruptive change through technologies or regulation and may be underperforming relative to other companies in its industry.

As of September 2020, about one-third of North American private equity firms' $6.5 trillion in assets were so-called "dry powder": cash or highly liquid securities that could be quickly invested at the right opportunity. The growth of private equity and other forms of private investment has, experts say, resulted in fewer companies going public and many more staying private for longer.

What Do Private Equity Firms Do?

Once private equity firms acquire a company, they encourage executives to make the company operate more efficiently before selling — or "exiting" — several years later, either through a sale to another investor or through an initial public offering.

"The number one factor private equity firms focus on now is the ability to grow the revenue of the company," Steven Kaplan, a professor of entrepreneurship and finance at the University of Chicago Booth School of Business, said in an email. Other considerations, Kaplan said, include reducing costs, refinancing existing debt and multiple arbitrage — the latter a term describing how private equity funds try to acquire firms trading below their intrinsic value.

Critics of private equity, notably U.S. Sen. Elizabeth Warren, a Massachusetts Democrat, argue that private equity firms' focus on turning a quick profit destroys long-term value and harms workers. But not everyone agrees. In some cases, particularly with distressed companies that can't pay their debts, private equity firms are often willing to lend money to businesses when traditional lenders such as banks won't. Defenders of private equity also note that their need for returns serves retirees — public pensions are responsible for about a third of investment into private equity funds. The median North American pension fund invests about 6% of its assets into private equity funds.

"To make money, you have to sell the company to someone," Kaplan said. "If you have destroyed long-term value, you are going to have a hard time exiting. The critics essentially assume that buyers are stupid on a grand scale. That's not a plausible assumption."

In response to the criticism, some private equity firms have begun offering equity to workers of the companies they acquire under the belief that if the company does well, everyone — and not just management and the fund managers — should share in a company's success.

"The problem is not private equity in general," said Eileen Appelbaum, a critic of private equity and co-director of the Center for Economic Policy and Research, a progressive think tank. "The problem is private equity leveraged buyouts."

Large private equity firms, she said, don't ultimately create wealth, but tend to extract it from companies through the use of leverage and other means. When selling companies, private equity firms frequently sell them to other private equity firms, often without full transparency. "They maintain a myth of doing really well," she said.

By contrast, smaller private equity firms that acquire a handful of smaller companies tend to do better at adding value because they tend to buy businesses that are more likely to need improvements. The acquiring firms can't as easily use the same kinds of financial engineering, she said.

What Returns Do Private Equity Firms Generate?

Even though private equity firms generally invest little of their own money into acquisitions, they typically receive both a small percentage of a company's total assets (usually 2%) as a management fee and a 20% cut of resulting profit from a sale of the company, all of which the U.S. government taxes at a significant discount to the firm under a tax advantage called "carried interest." Under this compensation scheme — called "two-and-twenty" — the private equity firm makes some money regardless of whether its portfolio companies are profitable.

Both Republicans and Democrats have called for the "carried interest" loophole to be closed. A bill backed by U.S. Sens. Joe Manchin and Chuck Schumer had aimed to partially close the loophole by only allowing firms to take advantage of carried interest once they've owned a company for five years — two years longer than current law. However, after opposition from Sen. Kyrsten Sinema — a critical vote for the legislation — this component of the bill was removed. Private equity firms argue that allowing fund managers to take pay as carried interest occurs only when the fund (and thus the companies) are profitable.

Private equity firms also market their funds as high-yield vehicles for institutional and wealthy investors, claiming the potential for returns higher than public stock indices like the S&P 500 and the Russell 2000 index of small-cap stocks. Additionally, private equity funds have a reputation for being less volatile than individual stocks, which can spike or crater based on something as minor as a tweet. The comparison isn't perfectly fair, however: Investors in private equity funds must lock their money into a fund for many years and don't start receiving distributions until later in the cycle, whereas retail investors with an S&P 500 mutual fund can buy and sell much more easily.

There are certainly private equity success stories in which distressed businesses are turned around and then eventually sold at a profit. But private equity has a reputation for aggressive cost management and saddling companies with heavy debt loads, which can result in neglect of vital but non-revenue-generating aspects of an investment and overconsolidation — acquiring multiple similar businesses, which reduces competition and can have far-reaching impacts on costs and labor.

How Do Private Equity Firms Use Debt?

The current version of private equity was born out of the leveraged buyout boom of the 1980s, in which cutthroat investors borrowed heavily to purchase companies and squeeze as much money as possible out of their purchases, usually by liquidating assets and looting pension funds.

The percentages of deals that have been financed with borrowed money have declined markedly over time. In the 1980s, according to Kaplan, deals were frequently consummated at 90% debt-to-enterprise value ratios, meaning nearly all of the money used for the acquisition was borrowed. If a company cost $100 million to acquire, the private equity fund would borrow $90 million and use $10 million of its own investors' money — equity — to finance the purchase. In the 1990s, the typical ratio declined to closer to 70%. Nowadays, typical leverage ratios are in the 50% to 60% range.

Buying a company using debt is called a leveraged buyout. It's similar to taking out a loan to buy a house and then renting it out to a tenant, with the cash flow from rent meant to pay down the landlord's mortgage.

Why does private equity use so much debt? Generally, it amplifies a private equity fund's expected returns on its investments, in part because the federal government allows interest payments on debt to be tax-deductible. Because it enhances returns, it also enhances the firm's expected profit. The trade-off is that heavy leverage increases the risk that the firm will be unable to make its debt payments.

One of the more criticized aspects of leveraged buyouts is that the debt used to finance the acquisition doesn't belong to the equity firm or fund. Rather, it belongs to the newly acquired company — and it can become an anchor that drags that business down.

The collapse of Toys R Us is a good example. Private equity giants including Bain Capital and KKR joined together in 2005 to purchase the flagging kids' retail giant for $7.5 billion, even as the retail toy industry was contracting amid increased competition from Amazon and other online sellers. Though the once-popular chain's revenues did not sink notably in the years that followed, the billions in debt related to the purchase continued to grow relative to the company's revenue as its owners reinvested excess cash into the business to make it competitive with online retailers. Eventually, debt holders lost patience and decided that they could get more of their money back if Toys R Us closed up entirely than if it continued operations.

In 2020, ProPublica spotlighted a hospital chain run by a private equity firm that had repeatedly tried and failed to unload its health care business on new buyers. Employees at hospitals under this umbrella told us they were sometimes unable to purchase basic supplies like sponges and IV fluids, elevators broke down regularly, and ambulance drivers' fuel cards were rejected at the pump. Yet the equity firm had already managed to squeeze out $400 million in dividends and fees for itself and investors.

By the time a potential buyer was found for that hospital chain in early 2021, its equity owners had saddled it with $1.3 billion in debt, while the firm and investors were set to walk away debt-free and having reaped a total of $645 million.

How Has Private Equity Expanded Into Health Care?

Between 2009 and 2016, the number of private equity deals involving health care businesses tripled, according to a PWC report. These investments weren't just in hospital groups, but also in staffing companies, particularly for specialties like emergency room physicians and anesthesiologists.

TeamHealth is a major medical staffing company and the country's top employer of emergency room doctors. It's also owned by private equity giant Blackstone and has been the subject of multiple ProPublica investigations.

In 2019, ProPublica joined with MLK50 to report on numerous low-income patients at Memphis hospitals who had been sued by a TeamHealth subsidiary over unexpected medical debt from ER visits. Such large-scale lawsuits had not been normal practice before Blackstone acquired TeamHealth in 2017. TeamHealth at first defended the lawsuits, arguing that it only went after patients who had not attempted to pay. But after the news organizations asked more questions about the lawsuits, TeamHealth announced it would no longer pursue them.

A subsequent review of tax returns, lawsuit depositions and court documents exposed how TeamHealth, after the Blackstone acquisition, had been marking up patients' bills to maximize its profit. Tax records for two of the company's Texas affiliates showed that they inflated their bills by nearly eight times the actual cost of the services provided. While much of that markup was billed but never collected, all of the additional profit from the amount eventually paid went not to the doctors but to TeamHealth. The firm said in a statement that it was fighting for doctors against underpaying insurance companies: "We work hard to negotiate with insurance companies on behalf of patients even as they unilaterally cancel contracts and attempt to drive physician compensation downward."

"These companies put a white coat on and cloak themselves in the goodwill we rightly have toward medical professionals, but in practice, they behave like almost any other private equity-backed firm: Their desire is to make profit," said Zack Cooper, a Yale professor of health policy and economics, about this practice.

In April 2020, we reported on TeamHealth cutting back on ER doctors' hours at a time when some hospitals were being overwhelmed with COVID-19 patients. Staffers employed by other equity-owned firms also told us their hours were being reduced or asked to take voluntary furloughs. At the time, the firms said these changes were needed to make up for the revenue shortfalls as a result of non-COVID patients canceling elective procedures and avoiding the ER. The firms also noted that they had not cut hourly rates.

How Has Private Equity Entered the Housing Market?

As the U.S. crawled out from the Great Recession, private equity firms took advantage of very low interest rates and the appetite of investors looking for seemingly stable places to stash their cash to venture into new fields like residential real estate. Amid a nationwide affordable housing crisis, private equity has quickly become a dominant player in the apartment rental business.

Some have likened the private equity cycle of acquire, restructure, resell, repeat to the practice known as house flipping, in which a buyer purchases a home, makes improvements, then quickly sells it at a profit. But as ProPublica reporting has demonstrated, the way private equity firms restructure the homes they purchase differs significantly from the changes a house flipper would make.

A house flipper's target buyer is someone looking to purchase a home, and so the upgrades the investor makes are intended to make the property more appealing to the people who will be living in it: Getting rid of popcorn ceilings and plywood paneling, replacing the kitchen appliances, slapping on new coats of paint and improving the curb appeal. Conversely, equity firms are eventually hoping to sell their housing assets to property management firms or other investors. These buyers are much less interested in whether the flooring is real wood or laminate, so long as the units are filled and tenants are paying their bills.

And that's what ProPublica heard when speaking to tenants at apartment buildings purchased in recent years by private equity investors. Renters at one San Francisco apartment building told us that after their management company was purchased by a large private equity fund in 2017, rents soared, trash collected in the hallways and on the rooftop deck, and the building's dedicated security guard was forced to cover a second property as well, resulting in nonresidents entering the apartment complex without permission. One tenant described having to heat her bathwater on the stove because she couldn't get anything but cold water from the tap.

Private equity is now the dominant form of financial backing among the 35 largest owners of multifamily buildings, our analysis of National Multifamily Housing Council data showed. In 2011, about a third of the apartment units held by the top owners were backed by private equity. A decade later, half of them were.

What Role Is Private Equity Playing in the Fishing Industry?

One way private equity firms try to generate greater returns is to acquire similar assets and operate them under the same umbrella, allowing firms to take advantage of economies of scale by sharing costs. That often means putting a greater burden on workers, whether it's nurses having to make due with fewer vital supplies, apartment employees having to work at multiple buildings or fishing vessels seeing their earnings chiseled away by equity owners who have shifted the costs of doing business onto individual operators.

"Tell me how I can catch 50,000 pounds of fish yet I don't know what my kids are going to have for dinner," asked fisherman Jerry Leeman in how private equity has taken over the New Bedford, Massachusetts, fishing industry.

While Leeman and his crew are not struggling to catch fish, their deal with equity-owned Blue Harvest leaves them responsible for much of their working expenses. They're charged for fuel, gear, leasing of fishing rights and maintenance on company-owned vessels. While some of the fish they cBlue Harvest did not respond to questions,atch typically sell for $2.28 per pound at auction, Leeman has netted only about 14 cents per pound. Each of his crew members earns about half that amount.

Their situation is a result of a race in recent years by investors to snatch up as much of the regional fishing industry as possible.

Backed by $600 million in funding from a private equity firm, which proclaimed an initial goal of "dominance" over the scallop industry, Blue Harvest has been acquiring vessels, fishing permits and processing facilities up and down the East Coast since 2015. It subsequently expanded into tuna, swordfish and groundfish — Leeman's specialty.

"What we're seeing is a fundamental transformation of the fishing industry," said Seth Macinko, a former fisherman who's now an associate professor of marine affairs at the University of Rhode Island. "Labor is getting squeezed and coastal communities are paying the price."

Blue Harvest did not respond to questions, but said in an email that the firm's focus was to advance its company strategy so employees "can be confident about their future."

"I cannot tell you how many times I have listened to employees scared to the core for themselves and their families due to unsubstantiated rumors about our company," Blue Harvest President Chip Wilson wrote in an email.

What's the Future of Private Equity?

Private equity has gone through multiple eras. In the 1980s, private equity firms focused on breaking up companies through highly leveraged buyouts. Starting in the 2010s, they began to focus on making large operational improvements to their portfolio companies, and the 2020s are expected to largely be the same. Some critics argue that the largest private equity firms have become so large themselves that they have become the very thing that they aimed to disrupt in the 1980s: large corporate behemoths that were slow, inefficient and had disparate business units. The size of private equity funds themselves continues to grow.

Absent massive regulatory changes that would make it too costly to finance buyouts or would entirely remove the carried interest tax savings, private equity firms will continue to acquire companies, restructure their operations, improve efficiency and seek to generate market-beating returns for their investors. “Most deals are competitive these days,” said Kaplan, the University of Chicago professor. “As a result, you cannot earn a good return without improving the business.”

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