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Private Equity as an Effective Tool for Capital Raising: Legal Risks and Countermeasures

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Abstract: Investors have contributed millions of dollars to private equity funds. These funds are now an indelible part of the world of trading. Private equity has gained popularity over the past ten years, which has sparked a number of discussions about it. Some people argue that private equity contributes a lot to the improvement of corporate governance and increase of the wealth. However, some hold the view that although private equity have some advantages, it has serious problems considering the misaligned interests between managers and investors and high debt ratios. By analyzing different opinions and gathering data about the performance of private equity, this article highlights the evaluation of private equity and LBO, including their unique advantages in mergers and acquisitions, and the potential risks they might bring to the corporation and investors of private equity funds. Also, the article advises some methods to cover the shortages including legislation, investor cooperation and information intermediaries for better use of private equity.

Keywords: private equity, corporate governance, misaligned interests, remedy

1. Introduction

Private equity investment (Private Equity or PE) was born in the 1940s. It is divided into venture capital, M&A capital, Pre-IPO capital and etc. Private equity investment takes long-term investment as the main investment strategy, supporting and encouraging managers of companies to focus on long-term value creation. Private equity can not only solve the financing difficulties enterprise but can also effectively improve the management level of the enterprise and enhance the core competitiveness of the enterprise, thus enhancing the industry value of the enterprise [1]. With these advantages, private equity has developed quickly over the past decade. Take China as an example: Private equity investment funds in China expanded significantly between 2015 and 2017, with an average yearly growth rate of close to 100%. By year's end, private equity investment funds had grown to a size greater than the stock financing of non-financial businesses during the same time period. China's private equity investment funds will be worth 9.87 trillion yuan by the end of 2020, 162 million yuan more than the stock financing scale of non-financial businesses during the same time period. The share of PE investment funds in the overall scale of social financing is also steadily increasing at the same time. In 2015, only 2% or so of China's PE investment funds were included in the total amount of social financing during the same time frame. However, by 2020, the percentage had increased to almost 4%, nearly doubled the percentage [2].

The rapid growth of private equity has raised questions about it. Critics state that private equity destroyed the industry by cutting costs at every opportunity in order to earn more when selling the companies, regardless of the long-term needs of these companies. Meanwhile, supporters say that all these things done to those companies by private equity are necessary for the reform of corporate governance. This article tries to give a basic analysis of both the good and bad things about private equity. Part I talks about the advantages of private equity and the example through data. Part II discusses the shortcomings of private equity and how these shortcomings arise. Part III intends to give some possible solutions of the shortage of private equity.

2. Advantages and Contribution of Private Equity

Private equity has very important effect on the improvement of corporate governance over the past few years. For large public company, private equity urges the managers to stay awake because they may face the risk of a takeover or the drop of the shareholder value [3]. For private company, private equity generally targets those which lack financial and managerial experience [4]. This part briefly analyzes the advantages of private equity and presents some data about the example of the contribution of private equity to companies.

2.1. Advantages of Private Equity

Firstly, private equity helps with the better corporate governance. The most serious defect of public company governance is the separation of ownership and control. While it is good that public companies can save money from raising capital from the public, it is difficult for investors themselves to manage the firm considering the number of investors. With so many shareholders of the company, they must hire managers to govern the company for them and this causes agency costs. Also, dispersed public-company shareholders have little interest in monitoring the managers, which gives these managers the chance to put their personal interests ahead of shareholders' interests or even the interests of the company. However, when private equity comes out, it is different. PE funds do not need to resort to dispersed equity because they can raise or borrow enough money, even for very large companies. A professional investment team known as a private equity firm (or "sponsor") typically creates a fund to pool equity funds, primarily from institutional investors. The fund uses that money, along with a large amount of borrowed funds, to buy and hold onto the businesses in its portfolio for many years. Through the single owner and manager, private equity acquisitions have the significant benefit of replacing scattered shareholders. They employ executives in a manner similar to that of public company boards. However, they are at least directly in charge of making important choices as well as hiring and managing top executives through board staffing. Private equity financing companies may be more willing than typical management to approve layoffs, spin off underperforming divisions, or even replace leaders in order to increase operational efficiency [5].

Secondly, private equity has more incentives and resources in monitoring corporate managers closely. Boards of private equity portfolio companies are different from boards of public companies in appearance and conduct. The former is smaller, comprised solely or mostly of private equity firm principals, and they convene relatively frequently. Most significantly, directors of private equity portfolio companies have much higher financial stakes than directors who serve on the boards of publicly traded companies. Private equity firms typically appoint the main principals in charge of the investment to the board of a portfolio company, and they purposefully link these principals' pay closely to the portfolio company's success [6]. Moreover, the heavy debt loads that private equity imposes on their portfolio companies assist private equity better control the managers. With the heavy loads, these managers will use the cash carefully and make decisions wisely. Compared to those public companies with stable cash flow, high debt ratios of portfolio companies of private companies force the managers to decide reasonably for the greatest use of money.

Thirdly, private equity can provide managers with more incentives many public companies have trouble dealing with conflict of interests between the incentives of shareholders and of managers, especially with so many separate shareholders. By aligning the motivations of corporate officials with those of shareholders, the private equity model can, in contrast, reduce the divergence. Evidence suggests that: (1) they are willing to pay managers more money than public company shareholders are willing to pay; (2) the compensation is more likely to be equity compensation, which is able to give managers more incentives; and (3) the acquisition and redemption are linked to significant liquidity events for the business, driving all parties to work towards a favorable exit for the private equity fund [7].

Fourthly, private equity plays a significant role in creating wealth. Private equity firms mainly seek to add value by enhancing operations, resource allocation, and improving financial structure. When it comes to operations, private equity firms can add value in a variety of ways, including by reducing production waste and raising sales-force efficiency. In terms of financial restructuring and allocation, private equity managers want to use the business as effectively as possible while seeking additional acquisitions [8]. Although the aim of private equity is to sell the company at a higher price, it still does a lot to improve the value of the company through the reform of corporate governance, which benefits the company in the long run. Apart from being able to restructure or streamline companies in ways that may be difficult for a publicly traded firm, private firms do not have to waste resources dealing with many government regulations. For those public companies, they need to obey the regulations such as Sarbanes-Oxley. But for private equity, it is not necessary, and it saves the cost. Private equity not only creates profits for the invested companies, but also brings higher returns to private equity investors because of higher investment barriers and lower investment liquidity. According to data fro, Bain and Company, over a 10-year period, US buy-out funds returned 14% annually, compared with 8% for stocks in the S & P 500. It is predicable to say that the high returns of private equity funds cause more people to invest them [8].

2.2. Example of Contribution

This part studies the business performance of small and medium-sized enterprises because of a certain representativeness. The scale of these enterprises is relatively small, and they have good development ability. Also, the financial data of these enterprises is easy to obtain. This section selects the listed enterprises on Shenzhen SME Board from 2014-2016 as study objects. The companies with incomplete data are excluded and the research samples are 117. There are 70 companies with PE investment and 47 companies without PE investment. This part chooses the return on assets as the operating performance to further verify the performance of private equity investment on corporate performance. The indicator reveals the ability of corporate assets to create profits and it is an important indicator to measure the profitability and development of the company [9].

Table 1: Variable Definition Table.

	Name of variable	Variable definition
ROA	Return on assets	ROA=Pure income/Total assets
PE	Private equity	1 represents investment with PE, 0 represents without
Lev	Debt ration	Lev=Total liabilities of the invested enterprise at the end of the listing year / total assets at the end of the year
Size	Scale of the company	Natural logarithm of the total capital of the invested enterprise at the end of the same year
Top	Equity concentration	The shareholding ration of the largest shareholder

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Table 2: Descriptive Statistical Analysis of Overall Sample (117).

	Mean value	Median	Maximum	Minimum	Standard deviation
ROA	0.0673	0.0623	0.1883	0.0059	0.0318
PE	0.5983	1.0000	1.0000	0.0000	0.4924
Lev	0.3001	0.2647	0.9652	0.0470	0.1747
Size	21.0049	20.7854	24.0970	19.8756	0.7326
Top	0.3901	0.3825	0.8002	0.0804	0.1353

Table 3: Descriptive Statistical Analysis of Enterprises with PE (70).

	Mean value	Median	Maximum	Minimum	Standard deviation
ROA	0.0674	0.0646	0.1883	0.0059	0.0312
Lev	0.2818	0.2426	0.6702	0.0610	0.1602
Size	21.0662	20.8294	24.0970	19.8756	0.7907
Top	0.3793	0.3796	0.6480	0.1243	0.1216

Table 4: Descriptive Statistical Analysis of Enterprises without PE (47).

	Mean value	Median	Maximum	Minimum	Standard deviation
ROA	0.0673	0.0612	0.1790	0.0091	0.0329
Lev	0.3123	0.2759	0.9652	0.0472	0.1839
Size	20.9137	20.7489	22.7616	19.9892	0.6337
Top	0.4061	0.3939	0.8002	0.0804	0.1535

According to the data above, the sample enterprises with private equity investment have higher business performance than those without private equity investment. The participation of private equity investment will improve the business performance of the enterprises. The average asset size of the total sample is 21.0049, which is similar between enterprises with private equity and those without. However, the average of enterprises with private equity is higher and the reason may be that the enterprises with private equity investment in the small and medium-sized board listed are better than those without private equity investment. Their companies are relatively large. The average debt ratio of the total sample is 0.3001. The average of the sample with private equity investment is lower than that of the sample without private equity investment. The average equity concentration of the overall sample was 0.3901, and the mean of the sample with private equity investment was higher than the mean of the sample without private equity investment. That is because private equity participation would reduce the shareholding of the major shareholders.

3. Disadvantages of Private Equity Inside and Outside

Private equity presents a unique model of corporate governance, which improves the value of portfolio companies. In this view, the private equity governance approach addresses the most pernicious types of owner-management misalignment, improves business performance, and increases investor returns. Given the additional risk and lower liquidity associated with private equity funds, it may be surprising that recent research suggests that returns on private equity over the past decade have not exceeded those of low-cost index funds. This section discusses the disadvantages of private

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equity, including the misaligned interests between investors and managers of private equity and the risks brought to the portfolio companies by private equity.

3.1. Disadvantages of Private Equity Inside

Disadvantages of private equity inside means the harm to investors of private equity because of the conflict of interests between investors and managers of private equity. There may be high agency costs because private equity managers' goals aren't always in line with investors. When investors give money to a manager and then give the manager, acting as agent, authority over how that money is invested, agency costs occur in private equity. Since managers have incentives to act against the interests of investors by abusing their power and knowledge asymmetries, their interests frequently do not coincide with those of investors, thus causing harm to investors [10]. It does in three ways.

Firstly, the compensation structure for private equity sponsors (that is, the private equity firm itself) creates a typical moral hazard situation: sponsors can get a lot of money from any profits on their investments, but mostly they do not have to undertake any risks from failed investment. The result is that private equity sponsors have financial incentives to take excessive risk in their investment strategies. If the investment is successful, they can win a large amount of money. Even if the investment is failed, the loss is for the investors of private equity to undertake. Private equity firms are generally get paid in two ways. First, they receive annual management fees. They get this type of money because the investors have committed that the firms can use a percentage of the capital they invested. Second, they receive a carried interest in the fund. That means they can receive money from the profits of their investments [11].

For management fees, they are not directly associated with the performance of portfolio companies but depend on the money from investors. Since a large part of private equity firm compensation comes from management fees, the managers of private equity will try their best to gather as many investors as possible. To attract those investors, they need to give them profits and make the most use of the money they gathered. Therefore, they have strong incentives to invest as many companies as possible, without thinking of the expected performance of the target companies because they have committed to the investors of the interests, and they need to fully use the capital they raised. This creates risks for investors, for they may be engaged in the unreasonable investment and are unable to exit. And these risks are not borne by the private equity firm itself.

For carried interest, it is a kind of compensation arrangement based on the performance of portfolio companies. This kind of interest does not face downside risk. If the value of the portfolio company drops, the loss will be undertaken by the private equity investors because the money is from them. The carried interest simply won't be triggered. Since the private equity managers won't lose money or face any punishment because of unsuccessful investment, they do not have the pressure to think carefully when facing risky investment decision. For example, one private equity firm is wondering about whether to invest a company at $100 million and there are two consequences: there are 30% chance that the value of the company will rise to $150 million and 70% chance that the value of the company will drop to $50 million. For equity investors, they will probably give up investing this company fearing the loss of money. But for the firm itself (or managers of private equity), it will probably choose to invest the company because it doesn't bear the loss and has opportunity to earn much from this investment.

Secondly, private equity investors have far less engagement in running private equity funds than typical investors of public companies although they contributed money in a similar way. They have few options for transferring or selling their equity stakes in the fund, limited governance rights, and limited information access [12]. First, equity investors are lack of voice, they have limited rights in making the decision on how the funds run. Unlike the rights of shareholders of companies which are listed on the law, the rights of these investors are limited to the voting rights of the amendment of the limited partnership agreement, the dissolution of the fund, or the removal of the general partner. Second, investors are lack of right to exit. The shareholders of public companies are able to sell their shares freely if they want to quit the companies. However, to private equity investors, exiting is a difficult thing. In most of the limited partnership agreements, investors are allowed to transfer their interests in the fund only when it is allowed by the firm, which is almost impossible. Therefore, private equity investors lose another useful way to push the firms. Third, investors are lack of information because in most of the limited partnership agreements, they are neither allowed to know the information about the structure and performance of their funds nor to transmit this kind of information among investors.

Thirdly, private equity funds treat investors differently, often giving preferred investors better terms. For example, an individual investor might sign a confidential agreement with a private equity fund. Through this agreement, preferred investor is given the privilege to pay lower fees than other, less favored investors. Apart from that kind of discount, a private equity fund might invite an investor to join in the management of fund, such as giving investor greater access to information about the performance of a portfolio company, sharing the investor with the thoughts of the fund in some investments, or even giving an investor the right to veto certain investments. Because some investors might be bribed by these rights given by their firms, it is harder for investors among one private equity firm to cooperate.

3.2. Disadvantages of Private Equity Outside

The proportion of the use of self-owned funds in the investment activities of private equity funds is often small A common way for private equity funds to invest companies is leveraged buyouts. That is, its investment in the target company is completed through debt financing activities. This will cause the debt ratio of the target company to rise sharply. If the target company operates well, the profit rises quickly, otherwise acceleration of loss may occur. That is, such use of a leveraged buy-out will magnify financial risk.

What's more, since private equity wants to control the company, it will possess a large part of shares of the portfolio company. With such large part of shares in hands, the aim of private equity is to sell the company at a high price, and it will sell all the shares at one time suddenly, which may cause a shock to the portfolio company. Also, to sell the shares at a high price in limited time, private equity will focus on how to improve the value of portfolio company in this given and short period of time and this may cause it to choose the decision without considering about the interest of portfolio company in the long term.

4. Possible Solutions of the Shortage of Private Equity

Although problems exist in private equity, it is still a useful way for companies to gather money and improve corporate governance. Also, a lot of investors really benefit from private equity, and just sometimes the return may not be as much as expected. Due to this situation, private equity cannot be abandoned. It just needs to be fix through some ways. This part will discuss the possible solutions to the problems of private equity and hope they might be useful to solve the dilemma.

4.1. Improve the Legislative System

When market are not able to solve problems, government should step in to when market fails to correct itself and encourage participants of business activities. For inside problems, government should find a form of regulation to reduces private equity's governance costs without burdening firms with costly and unnecessary red tape. This form of regulation needs to focus on balancing the rights between equity investors and equity managers. Investors should have better control over the private equity funds and be given more information. Meanwhile, there should be some kind of punishment given to managers to force them to be more responsible for their decisions, such as a fine for careless investment decisions. For outside problems, government should improve the risk control mechanism and better monitor the activities of private equity.

4.2. Encourage Higher-level Investor Cooperation

Another way to improve private equity is to encourage higher levels of investor cooperation. Large limited-partner investors are likely to band together and coordinate investment policies to avoid the path dependence and anchoring effects that have been present in the current governance structure. This could be done, for example, by enacting a private equity governance clause model or a limited-partnership agreement model. When these investors get together, they will be able to put more pressure on private equity managers to perform well by threatening to pull out of the funds at the same time. This also allows for a smoother dissemination of information partnership terms, side arrangements (if any), and fund activities and performance among investors.

4.3. Invite Information Intermediaries

The interests of private equity firms are not always the same as the interests of their investors. The pressure of losing reputation because of their misconduct is not as strong as expected. As a result, impartial information middlemen ought to be requested. Independent information intermediaries, like ratings agencies or outside consultants and advisors, could intervene to assist in bringing the interests of private equity companies and investors into alignment by staking their own reputations on effective results. To provide potential limited partners with an objective evaluation of the caliber of fund assets, they could look at fund structures, company management, and compensation plans [13].

5. Conclusion

The rapid growth of private equity in the past decades has proved that private equity truly has its irreplaceable advantages. Not only does private equity benefits the portfolio companies by improving corporate governance and giving more incentives to company managers, but it also provides people with a way to earn some money through fund investments. However, as it develops, problems rise too. The misaligned interests between equity sponsors and equity investors harm the interests of investors and it is hard for investors to limit the power of investors. Also, although private equity may give portfolio companies new hope, it may sometimes destroy a developing company. Taking all aspects into account, it is better to keep private equity a useful way of investment and financing while trying to figure out the problems. Government, equity investors and independent information intermediaries should be gathered for the improvement and better use of private equity. Hopefully in the future, with all the problems solved, private equity will bring more profits to all the people, agencies and companies engaged.

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