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Public-company model worse than private equity

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Rewarding executives with stock, a business school academic wrote in this paper recently, is a bad idea. It makes them manage the share price rather than run the company, which is harder work and less remunerative.

The idea is persuasive and prompts a related thought. Private equity has always argued its model is superior because of better incentives. With the business in the doldrums, that claim is often dismissed. But if public company incentives are seriously flawed, might it not be worth revisiting?

I should stress this is a different question from whether private equity is a good investment. As I wrote a couple of weeks ago, outside investors can be disappointed, if only because the attractions of the management model can make them overpay for a seat at the table. But that is not necessarily the model's fault.

Begin with the case against stock incentives, from Roger Martin, dean of the University of Toronto's Rotman business school. What they make executives do, he argues, is concentrate on manipulating expectations, rather than improving actual value.

They may lower expectations at the outset, so as to get more stock at a lower price. Then they make rash acquisitions, change the accounting treatment and so forth, to push the price back up before they exit. Stock-based compensation, Mr Martin argues, is the chief reason for short-termism in the public corporation.

It is worth noting the implicit premise. Manipulation only works if investors are suckers enough to fall for it. So it follows that the stock price and intrinsic value must be quite different things.

I have considerable sympathy with that position, but there is a caveat. After a decade of savage disappointment, equity investors have abandoned the notion of rational markets. Human nature suggests, though, that when equities eventually start rising again, the rational hypothesis will be back in fashion. Why blame the market when you are making money instead of losing it?

That apart, let us compare the behaviour of private equity. Here too, there is a caveat. Private equity will argue it is exempt from the short-term pressures of public markets. In a sense, so it is. But a fair proportion of companies taken on by private equity are eventually sold through public flotation.

I am reliably informed that by the time the ink is dry on a new-signed deal, the investment bankers will be round, setting out the targets and metrics that have to be hit, quarter by quarter, to heighten the company's attractions for a forthcoming IPO. And the people that have to fall for that, of course, are those same apparently irrational public company investors.

But the argument on incentives goes deeper. One senior private equity executive argues that public companies provide perverse incentives throughout the organisation.

The system of base salary plus bonus, he says, prompts junior executives to lower the expectations of their immediate superior so that their bonus will be triggered more easily. That can happen 10 or 20 times through the organisation, with each executive discounting what he/she is given before handing it on up. The result is systemic profit leakage.

In private equity, by contrast, the long-term plan is set at the top and pushed down. And since the bonus is based on a share of the exit price, there is no such incentive to play games.

That sounds plausible. In addition, it is claimed, private equity executives do not waste time on endless institutional roadshows. Instead, they sit with investors around a table. One head of a private equity-owned company told me that compared with his quoted-company days, this gave him an extra month a year for running the business.

That may be slightly exaggerated. Others will tell you that they still do roadshows, but to bankers rather than institutions. And the bankers have their own expectations, which have to be managed and met at regular intervals.

But there is a further argument in private equity's favour. Public company ownership has become hugely dispersed in recent years, with different shareholders having quite different objectives.

Communicating freely with each of them, even if feasible, would be forbidden by law on grounds of inside information. The UK's new stewardship code for investors, whereby each institution sets out its general objectives, is an attempt to address this.

All in all, the private equity model has a lot to be said for it. This is not a matter of choosing between it and the public model. But the recent crisis has proved instructive. It is not that the private model is better than we thought, but that the public model is in several respects worse.