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Staff Study #168

The Economics of the Private Equity Market

George W. Fenn, Nellie Liang, and Stephen Prowse
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Summary: The private equity market has become an important source of funds for start-up firms, private middle-market firms, firms in financial distress, and public firms seeking buyout financing. Between 1980 and 1994, the amount of private equity outstanding rose from less than \$5 billion to \$100 billion. Despite the market's extraordinary growth and its importance to many types of firms, it has received little attention in the financial press or the academic literature.

This study examines the economic foundations of the private equity market and discusses in detail the market's organizational structure. Drawing on publicly available data and extensive fieldwork, it describes the major issuers, intermediaries, investors, and agents in the market and their interactions with each other. It examines the reasons for the market's explosive growth over the past fifteen years and highlights the main characteristics of that growth. Finally, the study provides data on returns to private equity investors and analyzes the major secular and cyclical influences on returns.

The study emphasizes two major themes. One is that the growth of private equity is a classic example of the way organizational innovation, aided by regulatory and tax changes, can ignite activity in a particular market. In this case, the innovation was the widespread adoption of the limited partnership. Until the late 1970s, private equity investments were undertaken mainly by wealthy families, industrial corporations, and financial institutions that invested directly in issuing firms. Much of the investment since 1980, by contrast, has been undertaken by professional private equity managers on behalf of institutional investors. The vehicle for organizing this activity is the limited partnership, with the institutional investors serving as limited partners and investment managers as general partners.

The emergence of the limited partnership as the dominant form of intermediary is a result of the extreme information asymmetries and potential incentive problems that arise in the private equity market. The specific advantages of limited partnerships are rooted in the ways in which they address these problems. The general partners specialize in finding, structuring, and managing equity investments in closely held private companies. Because they are among the largest and most active shareholders, partnerships have significant means of exercising both formal and informal control, and thus they are able to direct companies to serve the interests of their shareholders. At the same time, partnerships use organizational and contractual mechanisms to align the interests of the general and limited partners.

The second theme of the study is that the growth of the private equity market has expanded access to outside equity capital for both classic start-up companies and established private companies. Some observers have characterized the growth of non-venture private equity as a shift away from traditional venture capital. They attribute the shift of investment funds to several factors, including the presence of large institutional investors that do not want to invest in small funds or small deals, a change in the culture of private equity firms, and a decline in venture opportunities. Although these factors may have played a role, the argument that non-venture private equity has driven out venture capital seems insupportable, as both types of investment have grown rapidly. We argue that the increase in non-venture private equity investment has been due principally to an abundance of profitable investment opportunities. Moreover, the available data on returns on private equity investments indicate that during the 1980s, non-venture investing generated higher returns than did venture investing, suggesting that private equity capital has flowed to its most productive uses.