If Private Equity Sized Up Your Business

by Robert C. Pozen

OVER THE PAST DECADE, directors and executives of public companies have increasingly found themselves under scrutiny from the managers of private equity funds—especially as acquisitions by such funds have come to involve firms with market capitalizations of more than $20 billion. For some public companies, this gaze has been welcome. Individual fortunes have been made in deals to take companies private. But for most public companies, the outsized returns of a few private equity funds have posed a challenge to their own directors and executives. If private equity can get that kind of performance out of a company, why can’t they?

Buyout firms would see opportunity for value enhancement in five key areas. Why not beat them to the punch?
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The rejoinders have become commonplace. Company officials claim, for example, that private equity derives a huge advantage from its insulation from Wall Street’s obsession with quarterly earnings. That argument goes only so far. Though it is true that a short-term focus can constrain the long-term growth plan of a public company, private equity funds must ultimately satisfy the temporal demands of Wall Street in order to reap capital gains on their investments. Others allege that the success of private equity is mainly attributable to collusive deals, excessive leverage, or overpriced IPOs. None of these allegations stands up to empirical analysis. (See the sidebar “The Reality of Returns.”)

More fundamentally, some commentators reject the notion that private equity funds have lessons to teach management, citing their mixed track record. Research by professors Steven Kaplan of the University of Chicago and Antoinette Schoar of MIT shows that the net returns (after fees) to limited partners of private equity funds on average have slightly underperformed the S&P 500 over the past two decades. However, when Kaplan and Schoar analyzed the performance of the topmost private equity funds, they found that the net returns (after fees) to limited partners have been significantly higher than the S&P 500 and, most important, that these higher returns have been persistent. The persistence of high returns by the top private equity funds over long time periods is unusual. In many areas of asset management, the top performers in one year do not maintain their high rankings in the following year.

At the moment, the growth of private equity appears to be slowing as interest rates rise and risk is generally repriced. But the era of private equity is far from over – the top funds have become very large and are likely to play an influential role in future market cycles. Thus, directors of public companies would do well to step back and look with cool eyes at how the top private equity firms have produced such high returns. This is not to suggest that directors of public companies should adopt every strategy or process employed profitably by private equity funds. Some fund managers engage in unsavory practices that should not be emulated – such as charging excessive transaction fees and “flipping” acquired companies. Rather, directors should try to understand to what extent successful practices of top private equity funds can be applied to the specific circumstances of their public companies.

A broad review of what happens at companies in the aftermath of private equity buyouts reveals five major thrusts of reform. These translate into five key questions that directors should pose to senior management and expect a thoughtful analysis in response:

- Have we left too much cash on our balance sheet instead of raising our cash dividends or buying back our own shares?
- Do we have the optimal capital structure with the lowest weighted after-tax cost of total capital, including debt and equity?
- Do we have an operating plan that will significantly increase shareholder value, with specific metrics to monitor performance?
- Are the compensation rewards for our top executives tied closely enough to increases in shareholder value, with real penalties for nonperformance?
- Have our board members dedicated enough time and do they have sufficient industry expertise and financial incentive to maximize shareholder value?

This is a wide-ranging set of questions. The first three relate to the operating strategy of the company, and the remaining two focus on the incentive structure for the company’s management and board. Put them together and they constitute the larger challenge to directors: How can we capture for our public shareholders the kind of value increase a private equity firm would seek? Let’s start with the matter of cash on hand.

Is There Too Much Cash on the Balance Sheet?

One of the hallmarks of private equity is keeping idle cash to a minimum. It is common practice for many private equity funds to require daily reports on cash levels. By contrast, public companies in the United States have built up huge amounts of cash over the past decade – $2.7 trillion for the S&P 500 at the end of 2006, as compared with $1.6 trillion at the end of 2001 and $0.88 trillion at the end of 1996.

Perhaps today’s historically high cash levels are partly related to the growing size of company balance sheets. But cash levels in many companies have also increased in relative terms, and the growing hoard is being justified in the usual ways: as a safety cushion to carry a company through lean times and as a war chest to fund new internal initiatives or make acquisitions. Directors of public companies should carefully evaluate whether either of these two justifications is overstated. It’s true that companies, especially those in cyclical industries, need rainy-day funds – many experienced particular difficulties in coping with the sharp economic downturn from 2000 through 2002. But how large a cushion is needed? Private equity funds have recently structured large acquisitions without substantial cash cushions in cyclical industries like semiconductors (an example is the buyout of Freescale Semiconductor by a consortium led by the Blackstone Group). Likewise, the husbanding of cash for near-term use in starting new ventures inter-

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nally or making major acquisitions can go too far. Directors should recognize that a large cash hoard can sometimes motivate management to engage in ill-considered transactions. Rhetoric of “synergy” and “transformation” accompanies many acquisitions, yet a substantial majority of them have in fact decreased the shareholder value of the acquiring company.

As directors of public companies are highly aware, the alternative to keeping excess cash is to return it to shareholders. One way to do this, favored in recent years, has been for the company to buy back stock. This tactic calls for some vigilance by directors. Despite the continuing announcements of stock buybacks, many public companies have accomplished only modest reductions in their share counts. Some companies do not fully implement their announced plans; others use a large portion of the acquired shares to fund executive compensation plans. Directors would be well advised to closely monitor the count of actual shares outstanding including shares for compensation plans.

Share buybacks do not automatically increase shareholder value, of course. A buyback makes sense only if the directors conclude that the company’s shares are currently underpriced by the market. The empirical results of share buybacks are quite mixed. Buybacks have generally increased the stock price of the acquiring company in certain periods (such as from 1999 to 2001) but not in others (2004 to 2005, for example). In recent years, share buybacks have tended to increase the company’s share price in certain sectors (technology, health care, and utilities) but not in others (energy, materials, and telecommunications).

The much more reliable way to increase shareholder value is to raise cash dividends. According to Citigroup research, stocks in the top quintile for dividend growth on average outperformed those in the bottom quintile by 12.6%.

The Reality of Returns

Even those who concede the performance advantage of the top private equity funds often denigrate them by claiming that their excess returns have been obtained through manipulative or short-term tactics. Do these claims stand up to scrutiny? Let’s consider three of the main allegations against the financial performance of private equity.

**Allegation 1:** Private equity funds buy out public companies on the cheap, primarily by colluding with their sitting executives to limit the acquisition premium for public shareholders.

Empirical evidence (from a 2006 analysis by professors Thomas Boulton of Indiana University, Kenneth Lehn of the University of Pittsburgh, and Steven Segal of Boston University) undermines the legitimacy of this claim. Over the past two decades, the average residual returns on the day of announcement were 20.2% for going-private transactions involving existing management and 13.6% for other types of going-private transactions.

**Allegation 2:** Private equity funds achieve excess returns simply by leveraging up the balance sheet of any company they acquire.

Again, the weight of empirical evidence proves the contrary. Improved operating performance was almost twice as important as increased leverage in an attribution analysis of gains in U.S. private equity deals (conducted by Robert Pease). A recent McKinsey study also found that the primary driver of value creation in a majority of the private-equity-fund deals studied was company outperformance, rather than market appreciation or financial leverage.

**Allegation 3:** Private equity funds achieve excess returns by quickly taking companies public in lucrative IPOs that then proceed to do poorly over the long term.

On this point, consider the empirical evidence presented by Jerry Cao of Boston College and Josh Lerner of Harvard Business School. They found that IPOs coming out of private equity deals between 1980 and 2002 outperformed the overall market and other IPOs launched at the same time (except for companies taken public within one year of being acquired by private equity).

None of these allegations, in short, withstands empirical analysis. Instead, the conclusion to be drawn from the persistently high returns of these funds is that their managers have developed the strategies and processes needed to obtain superior performance from companies. While some of these practices may be unique to the circumstances of private ownership, most are relevant to public companies.
from 1990 through 2006. Companies that raised dividends on average outperformed the market by more than 4% in the year they were raised, and companies that started paying cash dividends for the first time on average outperformed the market by more than 5% in that initial year.

A recent change in tax law has made the argument for raising dividends even stronger. Cash dividends used to be taxed at ordinary income rates to shareholders, while company buybacks of stock were taxed at the lower capital gains rate. That changed with the passage of the 2003 Tax Act; now the tax rates on both qualified dividends and most capital gains are 15%. Yet the average portion of earnings paid out in dividends by S&P 500 companies has been cut in half—from approximately 60% in the early 1990s to approximately 30% today. The main argument by company management against higher cash dividends is their inflexibility: It is very difficult to lower an existing level of cash dividends. Ironically, this difficulty is a key attraction to shareholders: Company management becomes subject to the discipline of paying this higher level of cash dividends year after year.

Is the Capital Structure Optimal?
Closely related to the high cash levels of public companies are their relatively low ratios of debt to equity. Private equity funds are well known for increasing debt and reducing equity in companies they acquire. It may be that the leverage employed by private equity is too great for the public markets, but the right level for many companies is likely to be higher than today’s, as we shall see.

Many executives resist increasing the leverage ratios of their companies. For them, it is a simple three-step argument. Increased leverage, they say, will lower the credit ratings on the company’s debt. In turn, that lower credit rating will substantially increase the company’s borrowing costs. Finally, the effect of both the increased leverage and the lower credit rating will be to substantially decrease the appeal of the company’s stock to public investors.

In reality, that logic is not borne out. It’s true that leverage beyond a certain point will lead to a lower credit rating for the company’s debt. However, the increase in borrowing costs for lower credit ratings has been modest until the recent turmoil in the debt markets. For example, during the initial four months of 2007, the option-adjusted spreads between a credit rating of single A and BBB (the two lowest rungs of investment grade bonds) were only 32 to 34 basis points, and the option-adjusted spreads between single A and BB (the highest rung of noninvestment grade bonds) were only 112 to 120 basis points.

More important, investors in public companies have become comfortable with firms that have higher leverage ratios. As shown by the exhibit “The Diminishing Impact of Credit Rating,” based on data from Goldman Sachs, the impact of a lower credit rating on a company’s market multiple has shrunk sharply over the past five years. Indeed, in 2006 there was almost no difference between the market multiple for companies with debt rated A– or higher (17.4) and the market multiple for companies with debt rated BBB (17.3).

Some company executives make a further argument against taking on more debt. They point out that a company is much less diversified than a private equity fund, which owns many firms, and therefore high debt levels are riskier for the company. But this perspective is too parochial; the proper viewpoint is that of the company’s shareholders. Since they can hold stocks in a diversified portfolio of public companies, shareholders can adjust their aggregate exposure to leverage to whatever level they wish. Other executives argue that during the past few years private equity has enjoyed a particularly favorable era of low long-term interest rates, which has now passed. But interest rates change rapidly and will again become favorable, so directors need to examine their capital structure on a regular basis.

The appropriate degree of leverage for a public company is seldom obvious. To discover it, the company’s directors should insist on a careful empirical analysis of
The Impact of Leverage on the Cost of Capital

When a company is taken private, often its capital structure is changed so that the ratio of debt to equity rises. Does it make sense for a public company to do the same—and if so, how much should it increase its leverage ratio? Discovering the answer requires an analysis of how taking on additional debt will affect the company’s weighted after-tax total cost of capital.

Consider the simplified example of a company with $1 billion in capital. In Scenario A, that capital is composed of $800 million of equity with an expected return of 12% and $200 million of debt with an interest rate of 6%. Under Scenario B, the equity of the company is reduced to $600 million, and its debt is increased to $400 million. The analysis of Scenario B is based on the assumptions that, in this capital structure, the expected return on the equity will rise from 14% to 17.5% and the interest rate on the debt will rise from 6.5% to 7.5%.

All scenarios are based on the current tax treatment of dividend and interest payments by companies—no tax deductions for dividends and full deductibility of interest payments (at an assumed corporate tax rate of 30%). While the debt-to-equity ratio in a company’s capital structure may be immaterial in a perfect market, this differential tax treatment makes high-equity capital structures less attractive than high-debt capital structures. Thus, the weighted after-tax cost of total capital in Scenario A, with 80% equity, is the highest at 10.44%. By contrast, the weighted after-tax cost of total capital is only 10.15% in Scenario C because of its high-debt capital structure. If the leverage ratio of Scenario C is too high for the company in the judgment of its directors, they should carefully consider Scenario B, which has less debt and a weighted after-tax cost of total capital of 10.22%—meaningfully lower than the 10.44% in Scenario A.

<table>
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<tr>
<th>Scenario</th>
<th>Equity (in millions)</th>
<th>Expected return on equity</th>
<th>Debt (in millions)</th>
<th>Interest rate on debt</th>
<th>Weighted pre-tax cost of total capital</th>
<th>Weighted after-tax cost of total capital</th>
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<tr>
<td>Scenario A</td>
<td>$800</td>
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<td>$200</td>
<td>6%</td>
<td>9.6%</td>
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<tr>
<td>Scenario B</td>
<td>$600</td>
<td>14%</td>
<td>$400</td>
<td>6.5%</td>
<td>8.4%</td>
<td>8.40%</td>
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<tr>
<td>Scenario C</td>
<td>$400</td>
<td>17.5%</td>
<td>$600</td>
<td>7.5%</td>
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various combinations of debt and equity to arrive at the lowest weighted after-tax cost of total capital, including debt and equity (see the exhibit “The Impact of Leverage on the Cost of Capital”).

Does the Operating Plan Significantly Increase Shareholder Value?
While increased leverage has contributed to the success of private equity, improved operating performance of acquired companies has been more important. In a 2005 study of 100 businesses owned by private equity in Europe, Ernst & Young calculated that the value of these businesses grew at twice the annual rate achieved by public companies in the same country and the same sector. Why? “Making long term improvements in the profit growth and value of businesses does not come from cost cutting or financial engineering,” concluded the report’s authors. “It comes from focused investment, making the few key changes happen fast, and the benefit of shared incentives of investors and management.”

A similar conclusion was presented in a 2005 McKinsey study of 60 deals by 11 private equity firms with above-average track records. In 63% of the deals studied, the primary source of value creation was “company outperformance,” as compared with 32% from “market/sector appreciation plus financial leverage” and 5% from “arbitrage.” In explaining this superior company performance, the McKinsey study emphasized that private equity firms devise value-creating plans and execute them effectively.

Board members of a public company might not recognize that as an area of shortcoming. In all probability, they hold a strategy session every year. But how transformative is the thinking at this session? Is management pressed to develop a truly bold operating plan, like the one put in place after KKR acquired Duracell in a 1988 leveraged buyout? The battery company launched a mass marketing program around the world and spent heavily on innovative TV advertising. As a result, Duracell made significant gains in market share and, eight years later, was sold to Gillette at a large premium.

The work doesn’t end with the design of a great operating plan. Directors of a public company should subsequently monitor its implementation as closely as private equity does. Those firms subject companies to “near continual review and revision,” the McKinsey study revealed, tracking progress against key performance indicators. If a company falls behind plan, private equity acts decisively, according to Ernst & Young: “Where necessary, plans were redrawn, management changed, and sometimes investment was increased.”

There are no generic formulas to be derived from how private equity improves operating performance, but there is a typical toughness in controlling costs. There are no corporate jets or lavish dining rooms for companies owned by private equity. Public directors hoping for similar kinds of performance gains should measure the company against its peer group on several metrics, such as general administrative costs and total operating costs relative to gross profits.

Improving operating performance requires astute business judgment about where to cut back within existing units. Public company directors should also look closely at whether noncore businesses should be sold—a favorite technique of private equity to improve operating performance. On the other hand, private equity firms often invest to increase revenues in acquired companies. One example is General Nutrition, whose private equity owners reinvested cash flow to open more stores. Another involves a small oil and gas company, which Morgan Stanley Capital Partners helped to develop additional production. Looking outside, public directors should urge management to find acquisitions at reasonable prices that would consolidate the company’s market position or realize economies of scale—as did the acquisition of Bethlehem Steel by Wilbur Ross after he had bought LTV’s steel plants.

Bold strategies and effective implementation serve shareholders well but require a highly creative and motivated management group. Does the average public company provide executives enough incentives to pursue the company’s objectives? Are board members appropriately dedicated to the task? These are the questions we turn to next.

Is Executive Compensation Tied Closely Enough to Shareholder Value?
One of the distinguishing characteristics of private equity funds is how they compensate the top executives of the companies they control. To begin with, the equity stakes held
by senior management in these companies are much larger than in public companies. When Steven Kaplan studied the matter, he estimated that the stock interest of CEOs increased by four times when a company was acquired by private equity. More recently, McKinsey research found that private equity offers top management a system of rewards equal to 15% to 20% of the company’s total equity.

However, these equity incentives are offered to a much more select group of executives in private equity deals than in public companies. As the McKinsey study reports, “Such incentives heavily target a company’s leading officers as well as a handful of others who report directly to the chief executive.” Those other executives are chosen on the basis of their direct contribution to increases in shareholder value. The implication for directors of public companies: Reconsider the practice of spreading equity awards broadly across the employee population and instead concentrate the awards on the smaller group of executives who are the proven drivers of company performance.

Furthermore, those few company executives do not actually receive any rewards from their relatively large equity packages unless the private equity fund that owns the company realizes a substantial gain. This often occurs when the company is sold to a third party or when a portion of its shares is sold in a public offering – two events that are not common in already public companies running long-standing businesses. But public company directors should learn the general lesson from private equity that stock rewards should be tied as closely as possible to increases or decreases in shareholder value. More specifically, public directors should resist the recent trend toward shifting equity incentives from stock options to restricted shares.

When directors grant stock options with an exercise price equal to fair market value at the time of grant, they are ensuring that the recipient will do well if the company’s share price rises but will have no gain if the company’s share price stays the same or declines. By contrast, when directors make grants of restricted shares, even if those shares vest over several years of continued employment, they are effectively guaranteeing a substantial gain to the recipient regardless of how the company’s shareholders fare. If the company’s share price rises, the value of the restricted shares will also appreciate. If the company’s share price stays the same or declines, the restricted shares will still confer a substantial gain on the executive receiving them – just because that executive remained on the job for the requisite number of years.

If they choose to rely more heavily on stock options than on restricted shares, directors of public companies are likely to face opposition based on the potential for windfall profits from stock options. During the 1990s, some executives reaped huge profits from stock options on account of the sharp rise in the general stock market, rather than the superior performance of their particular company. However, a disconnect between executive gains and company performance can be reduced by placing conditions on the exercise of stock options. Options at Schering-Plough, for example, are not exercisable unless specific earnings targets are met, and options at Bristol-Myers Squibb are not exercisable unless the company’s share price exceeds 15% of the price at the initial grant. More radically, the exercise price of a stock option could be adjusted each year to reflect the rise or fall of an appropriate stock index for the company’s industry. If the tax and accounting complexities of index-based options can be overcome, this approach ensures that executives will realize gains only if the company’s shares do better than those of their industry peers – regardless of whether the general stock market is rising or falling.
Most important, directors of public companies should learn from private equity not to allow top executives to leave with large exit packages despite poor performance. How is it that the CEO of Phillips-Van Heusen, for example, was able to leave the company after only eight months with a total exit package of $26.2 million, of which $10.5 million was severance? Should the CEO of Pfizer have received a total of $198.8 million, including $34.2 million in severance, after six years in which the company’s stock substantially underperformed the market? Outsize exit packages are usually rationalized on the grounds that they are required by employment contracts or formulas built into benefit programs. But directors should object to contracts or programs that provide executives with substantial bonuses or equity grants regardless of performance, except as necessary to replace lost awards when a senior executive is recruited from another company. Private equity has recruited many CEOs with proven talent by offering large rewards for company outperformance without contractual protections for executive underperformance.

Do Directors Devote Enough Time and Have Enough Incentive to Increase Shareholder Value?

Another area in which companies controlled by private equity differ from public companies is in the composition of their boards of directors. To begin with, the boards of private equity companies are small, with only four to eight directors versus the ten to 14 directors in most public companies.

The larger boards of public companies result partly from the requirement that the three main committees of a public company—audit, compensation, and governance nominating—be composed solely of independent directors. This independence requirement also drives a more significant difference between the boards of public companies and private equity companies: the depth of directors’ expertise in the company’s business. Private equity firms recruit directors with extensive operating experience in the same industry as their portfolio companies. Elevation Partners, for example, is buying 25% of Palm in a recapitalization deal; once the transaction is final, Jon Rubinstein, who until recently led Apple’s iPod division, will join as board chairman. Fred Anderson (former CFO of Apple) will also join the board of Palm.

In public companies, by contrast, many capable candidates with industry expertise do not qualify as independent because they have substantial ties to competitors, service providers, large suppliers, or customers. Thus, the independence requirement reduces the size of the pool available to public companies of potential directors with skills needed to increase company value.

Most distinctively, the expert directors recruited by private equity spend much more time on company business than do the directors of public companies. The boards of public companies usually meet six times a year with each meeting lasting a day and a half on average. Add to that the time public directors spend on review of materials, travel to meetings, and conference calls between meetings, and the total time spent on company business by public directors ranges from 132 to 183 hours a year, according to various surveys by search firms.

By contrast, directors of companies owned by private equity typically spend three to five days a month on company business, and even more at the start. For instance, according to a survey by Ernst & Young, one director of a company owned by private equity met with the management team on a daily basis for the first few months while the operating plan and new processes were hammered out. He then “stepped back, letting management take the helm, but even then continued to spend four days a month, on average, communicating with the team.”

Not surprisingly, there are significant differences between director compensation in public and private equity companies. The total annual compensation (including equity awards) per director in S&P 500 companies, according to a 2005 Spencer Stuart study, was on average $136,360. In most of these companies, directors may choose to take some or all of their annual fees in deferred equity units or restricted shares. This provides a modest link between rewards to public directors and increases in shareholder value, but the upside is limited. On the other hand, if a public company gets into trouble financially or legally, its directors face substantial risks of personal liability and reputational damage as well as extensive extra demands on their time.

Since directors of companies owned by private equity expend much more time and effort than their public-company counterparts, they deserve a much higher level of compensation. But this higher level of compensation does not come in the form of annual fees. Directors of companies owned by private equity hold substantial equity in those companies and share in the performance fees of the private equity funds—typically, 20% of the returns realized by these funds.

Given these differences between private and public boards, some commentators have complained about “compliance” boards at public companies—directors concerned mainly with minimizing downside risks rather than maximizing shareholder value. One possible approach would be to adopt the private equity model at certain public companies, as suggested by Malcolm Salter. The directors of these public companies would spend three to five days a month on company business and would severely limit their directorships in other organizations. These boards would be composed of only four to six directors, who would have extensive industry-specific experience. To provide more incentive to create shareholder value, these directors would be paid an annual fee of $30,000 to $50,000, together with stock options valued at $300,000 to $500,000 a year.
This board model from private equity might seem too intrusive or impractical to some CEOs, such as those leading companies with multiple lines of global businesses. It would be difficult even to find directors with global expertise in all these business lines who would qualify as independent under current standards for listed companies. But a CEO from a smaller, more narrowly focused company might welcome strategic assistance and regular consultations from a small coterie of industry experts with strong incentives to grow the business. Such companies are more likely to find directors who qualify as independent by recruiting from the ranks of retired executives from the industry and its service providers.

Getting the Message
Because of the excess financial returns achieved by the top equity funds over the past decade, the pressures on public companies have been rising. It’s no surprise, then, to see public companies taking heed. IBM, for example, recently took a page out of the private equity playbook. It had $10.8 billion in cash equivalents and only $700 million in long-term debt at the end of the first quarter of 2007. On April 24, 2007, the company announced that it would use its cash to boost its quarterly dividends by one-third, going from 30 cents to 40 cents a share, and that it would use its cash plus new borrowings to buy back $15 billion worth, or 10%, of its outstanding shares. The company was promptly rewarded for applying this value-enhancing technique commonly used by private equity: The price of IBM shares rose by 3.5% on April 24.

This is only one example of a broad trend under way. Companies far too large to fear imminent takeover from private equity funds are learning from them. To formalize these lessons, large companies would do well to go through an in-house simulation of a private equity takeover. This would involve creating a SWAT team of aggressive internal staffers and instructing them to play the part of the private equity fund managers. What would be their strategic plan? How would they alter the capital structure? Which units would be cut and which grown, with an understanding that there were no sacred cows? Should the company concentrate its equity awards on a more select group? Should the company downplay grants of restricted stock in favor of stock options with performance conditions?

For companies with market capitalizations below $20 billion, the exercise takes on more immediacy because those firms are within easy shooting range of private equity funds in a favorable interest rate environment. Directors of some companies this size have adopted certain strategies before their hands are forced by overtures from private equity. For example, after watching private equity funds acquire rival hospital operations in leveraged buyouts, Health Management Associates announced its own recapitalization early this year – taking on $2.4 billion in new debt to finance a one-time dividend of $10 a share. As HMA’s CEO explained, the move allowed the company to “shift to a lower cost of capital, give immediate value to our stockholders, and give them the ability to share in the future value of the company.” HMA’s stock price rose 2.6% on the day of the announcement.

Smaller public companies in one line of business, even those not facing threats of immediate takeover, should consider switching to the private equity model of a small board composed of retired industry executives paid primarily through stock options. These are the companies that have the most trouble recruiting and paying for directors, with their heightened concerns about personal liability and the increased board time devoted to compliance procedures. At the same time, because these companies are operating mainly in one line of business, expert directors willing to make a substantial time commitment can make significant contributions. In other words, these are the companies where the small expert boards have proved effective for private equity.

Regardless of the ebbs and flows of private equity deals, wise directors of public companies will find the best that private equity has to offer and apply those lessons proactively to their companies. They will keep company cash as low as feasible, reduce the company’s weighted after-tax cost of total capital, and make the tough decisions required to improve operating performance. And they will draw upon the pay model of companies owned by private equity in tying executive compensation more closely to actual increases in shareholder value – without guarantees of large severance payments unrelated to performance.