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Private equity buy-outs create value by applying brakes on expansion [Print](#)

By Daniel Aronoff

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From Mr Daniel J. Aronoff.

Sir, In observing "the tendency for companies to revert to the industry mean in order to keep growing", John Gapper may have inadvertently served up an important explanation of the private equity phenomenon ("Be blunt if you want to keep it cheap", February 26). It is not uncommon, as Mr Gapper points out, for companies to dilute their performance in a sometimes manic quest to expand.

Perhaps it is in the nature of equity ownership, where returns are not fixed and investors embrace risk in order to achieve high profit, to encourage management to seek growth at all times and, sometimes, at all costs. Starbucks is suffering the ill-effects of such an approach, and the demise of Bob Nardelli at Home Depot may similarly have issued from an unrealistic expectation that he must deliver growth through diversification into uncharted territory as Home Depot's traditional market became saturated. When the practicable possibilities for expansion are limited or risky, returns are maximised by accepting slow growth in the business's existing market. In such circumstances, the drive to expand will lower the value of the business.

That is where, at least on some occasions, private equity has contributed to value. When a business is destroying value by over-expanding, an opportunity exists to create value simply by putting the brakes on expansion. A private equity buy-out can effect this salutary outcome. Moreover, a stable business in a stable market is well suited to the debt financing undertaken by private equity firms to finance their acquisitions. Ironically, this restraint may be the source of criticism that private equity firms are an anathema to employment growth. It is also possible that many private equity firms fail to recognise the implication that re-introduction into the equity markets may again dilute value.

They have not yet reached that part of the story.

Daniel J. Aronoff,

President and Chief Executive,

The Landon Companies,

Bloomfield Hills, MI 48304, US

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