Chapter 1

Private Equity: Investors as Managers

Aidells Sausage Company was founded by Bruce Aidell in 1983. A microbiologist and foodie, he developed an artisanal line of chicken sausage products that were widely popular in the San Francisco Bay Area. In 2007 private equity firm Encore Consumer Capital bought the company, provided financial management and operational and marketing expertise, and dramatically expanded its market reach. The company had grown from 140 to 350 employees by 2010, when it was sold to Sara Lee.

Mervyn's Department Store chain was another well-known and popular brand serving the Bay Area and other cities throughout California when it was acquired by a private equity consortium led by Sun Capital Partners: in 2004 its 257 stores and 30,000 employees were acquired in a leveraged buyout worth $1.2 billion. The private equity firms paid $400 million of their own and their investors' cash and debt-financed $800 million using the company's assets as collateral. They soon sold off the property assets, retiring the debt backed by those assets and paying themselves back. The stores were required to lease back the property that housed their operations and pay inflated rents on facilities they had previously owned. The consortium then had the department store chain take on $400 million in additional debt and used the funds to pay dividends to its private equity owners. The store managers were required to make across-the-board job cuts and were unable to maintain long-term relations with vendors. Several rounds of top management left. Mervyn's filed for bankruptcy in 2008: the department store chain had a $64 million loss that year—less than the $80 million increase in rent payments following the buyout by private equity. Over the four years of private equity ownership, 30,000 people lost their jobs.

Private equity firms have emerged in the last three decades as part of a group of new financial actors—or "intermediaries"—that raise large pools of capital from wealthy individuals and institutions for investment funds.

These funds undertake risky investments that promise to deliver higher-than-average returns. Private equity funds buy out companies using high levels of debt—referred to as "leverage"—that is loaded onto the acquired companies. The use of debt to take over ownership of mature operating companies in leveraged buyouts and actively manage them are the characteristics that distinguish private equity funds from venture capital or hedge funds. Venture capital and hedge funds are also investment funds that mobilize private pools of capital, but their business models differ substantially from that of private equity.

Why Do We Focus on Private Equity?

We undertook an examination of private equity (PE) in this book because it is the financial intermediary that has the most direct effect on the management of mainstream businesses in the U.S. economy. In 2013, 2,797 private equity firms were headquartered in the United States, with investments in 17,744 U.S. companies, according to the Private Equity Growth Capital Council (PEGCC), the industry's association and chief lobbying group. Since 2000, PE-owned companies have employed some 7.5 million people. Roughly 35 percent of PE investments come from U.S. pension funds, especially public pension funds. Thus, the actions of private equity partners affect not only the employees in the companies they own and the suppliers with whom they do business, but also the retirement income of millions of working and retired Americans.

PE-owned companies are similar to publicly held companies in several ways. Both are under pressure to maximize short-term shareholder value and have an array of financial and organizational strategies to do this. But there are also fundamental differences between them that lead to differences in managerial risk-taking and in stakeholder outcomes. The financial structure and light legal regulation of private equity firms allow them to much more aggressively pursue shareholder value at the expense of others with a stake in the company—its suppliers, employees, customers, and creditors.

A key difference between publicly traded companies and those owned by private equity lies in the way partners in private equity firms are rewarded. In the leveraged buyouts undertaken by PE funds, about 70 percent is funded by debt and the remaining 30 percent by equity, which comes almost entirely from the funds' outside investors. The general partner (GP) in the PE fund, who is a partner in the private equity firm that sponsored the fund, makes the decisions about which companies to acquire for the fund's portfolio, how much debt to use, and how to manage the companies. General partners invest 1 to 2 percent of the equity in the PE fund but receive 20 percent of the returns once the fund achieves a "hurdle"—usually an 8 percent rate of return. The structure of these deals allows the

GPs to take high risks using other people's money. Their goal is to sell the portfolio company in three to five years at a higher price than they paid to acquire it. The downside of the extensive use of debt is that it increases the risk that the portfolio company will experience financial distress. On the upside, however, debt magnifies the returns to the private equity fund. The general partner, who has put up 2 percent or less of the equity, has little at stake if debt drives the acquired company into bankruptcy, but much to gain from a successful exit from the investment. This is a classic case of what economists call "moral hazard." The general partner who makes the decision to load the portfolio company with debt that it is obligated to repay bears very little of the potential costs associated with those risks.

Several other differences are worth highlighting. First, the companies that private equity firms take private are lightly regulated by the Securities and Exchange Commission (SEC) and thus are lightly subject to the same requirements for transparency and accountability as public companies. The general partners can require the portfolio companies to pay them personally, collecting "advisory fees" and "management fees" that can run into millions of dollars annually; no CEO of a publicly traded company can make any such requirement of the company's divisions or subsidiaries. The GPs can also use other financial engineering strategies that would be unacceptable for public corporations to undertake owing to their adverse reputational consequences and shareholder opposition. Second, investors in private equity funds turn over full decision-making power to the general partner of the fund and make a capital commitment for the life of the fund, typically ten years. As a result, PE general partners are not subject to the kind of immediate shareholder pressure or public scrutiny that public companies face. Shareholders in public companies are typically more risk-averse and can pull out their money at any time.

This difference in transparency and shareholder accountability allows private equity to take on substantially more debt than public companies. Private equity turns on its head the capital structure of the typical public corporation: the capital structure of a company acquired by a private equity fund is often 70 percent debt and 30 percent equity, whereas the structure of a publicly traded company is typically 30 percent debt and 70 percent equity. High debt is a high-risk strategy that, when successful, enables outsized returns for the private equity fund; but it also increases the likelihood of financial distress and bankruptcy for portfolio companies, especially in economic downturns. The empirical evidence we review shows that private equity–owned companies historically have had twice the bankruptcy rates of publicly traded companies, and these rates were particularly high after the economic recession of 2007 hit.

Third, the law treats PE firms and their funds as *investors,* even though they behave as *managers* of the companies they buy and sell and as *employers* of the people who work in those companies. PE funds both own and

Table 1.1 Differences Between Private Equity–Owned and Public Corporations

Dimension	Private Equity	Public Corporations
Risk-taking	High	Low
"Moral hazard"	High	Lower
Capital structure	70 percent debt, 30 percent equity	30 percent debt, 70 percent equity
Use of junk bonds	Considerable	Low
Asset sales for profits	Higher	Lower
Dividend recapitalizations	Frequent	Rare
Fees	Key part of earnings	No advisory fees
Taxes	Capital gains rate	Corporate rate
Legal oversight	Low	High
Transparency	Low	Higher
Accountability	Low	Higher

Source: Authors' compilation.

take control of companies, appoint boards of directors, hire and fire top executives, and set the direction of business strategy and employment policies. The general partners and their legal team often negotiate directly with unions in collective bargaining or demand concessions in wages and benefits as a condition of taking over the company. Unlike public companies, however, they are not held legally or publicly accountable for many of the outcomes of their decisions, a pattern we document throughout the book. When something goes wrong in a private equity–owned company, the negative reputational effect typically falls on the company itself, as the private equity owner is behind the scenes with little visibility.

The fundamental differences between private equity–owned and public corporations are summarized in table 1.1. When private equity firms take over companies, moral hazard problems often ensue because the general partners in these firms, in a position to make greater use of other people's money than their own, engage in high-risk behaviors. These include financial engineering strategies such as the substantial use of debt, junk bonds, and other high-risk financial tools; asset sales for profit; and dividend recapitalizations. They also charge large fees not available to public corporations, are taxed at the lower capital gains rate rather than the corporate tax rate, and face little legal oversight—leading to low transparency and accountability.

In sum, the private equity business model represents a test of the notion that pursuing shareholder value aggressively is a good thing by putting the shareholders even more in charge. The argument is that leaving executives in charge of decisions about how companies should be run is problematic because managers have interests that are independent of those of the owners. What happens when decision-making is taken out of the hands of executives and investors take charge of business strategy and operations to a greater extent, as the proponents of the private equity business model propose? The results matter because they inform the broader debate about the consequences of advancing shareholder interests and power even further.

Private equity's controversial business model has ridden at least three waves of major public debate. In the 1980s, leveraged buyouts (LBOs) were viewed as a panacea that solved the problems of the waste inherent in diversified conglomerates and the misalignment of investor and manager interests—a panacea that ended in scandal, disappointing returns, and disgrace by the end of the decade. LBOs seemed to disappear until their reincarnation as private equity in the early 2000s. Suddenly, in the boom years of 2005 through 2007, the media was awash with stories of brilliant financial management and dramatic returns to investors while labor unions took aim at private equity's destruction of jobs and accused the industry of asset stripping and vulture capitalism. With the onset of financial crisis in 2007, public concern shifted to systemic risk and banks that were "too big to fail," and private equity again became a small side show. That changed in 2012 when Mitt Romney became the Republican presidential candidate. His record as a founder and leader of the private equity firm Bain Capital became a centerpiece of debate when credible investigations revealed a series of bankruptcies and job losses in companies bought out by Bain.

In each round of debate, advocates and critics have presented polarized views of private equity's contributions to, or destruction of, the American economy. The Private Equity Growth Capital Council highlights case studies and sponsors research to show how private equity has turned around distressed companies, provided operational expertise, and infused small-cap and mid-cap businesses with the sophisticated management and resources they need to expand to new levels of development. Investigative journalists, trade unions, community advocates, and bankruptcy courts have countered with evidence of healthy companies that fell into distress and bankruptcy when private equity owners loaded them with debt, stripped their assets, and privileged short-term cost-cutting over long-term growth.

How can a single type of investment fund using the same business model yield such polar opposite results? What is private equity, and how does it make money? How much does it influence the U.S. economy, and why does it matter?

This book provides an accessible roadmap to private equity at work. We sort out the evidence on what private equity does, how it makes money, and how it affects the companies it buys, the suppliers and employees it hires, and the creditors and investors it draws on. The book addresses public debates about the role of private equity in the U.S. economy. It informs research in the fields of management and organizations, human resource studies, and labor and employment relations, where the impact of capital markets and ownership structures on companies is of great interest but studies of specific actors is thin. It provides research-based recommendations for public policy changes that could reduce the excessive use of financial engineering strategies and encourage wider use of strategies that improve operations and thus lead to more beneficial outcomes for the wide range of stakeholders involved—the PE-owned companies, their creditors, employees, vendors, and pension funds, and the limited partners who invest in private equity funds.

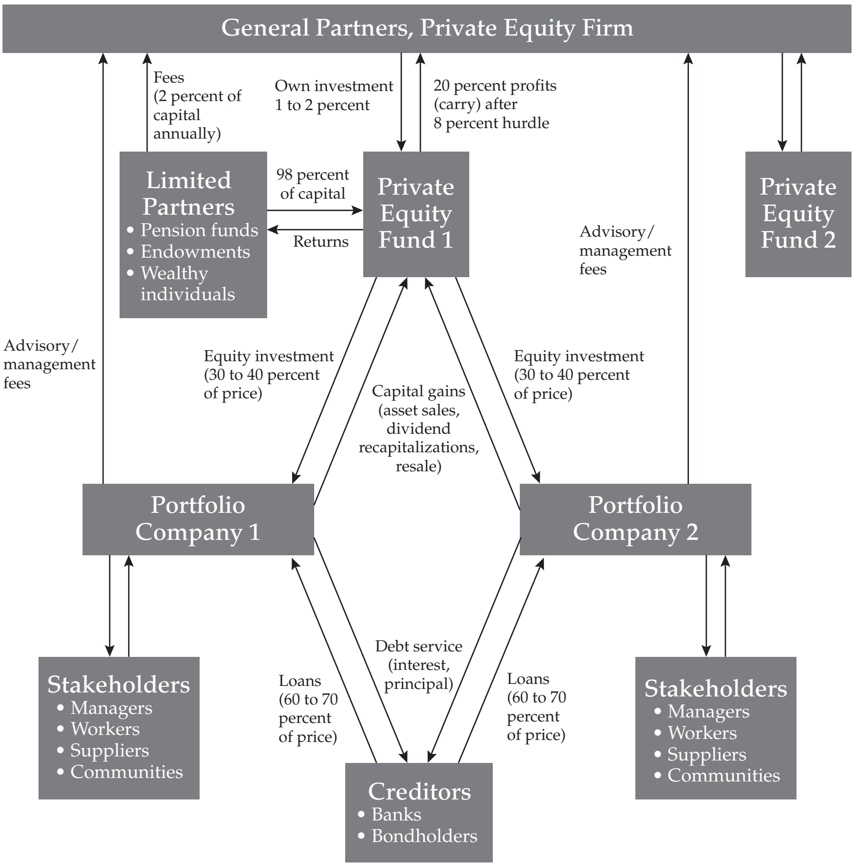
The Organization of the Book and Findings

In chapter 2, we begin by placing private equity in context and linking its emergence to the deregulation of financial markets, labor markets, and industries and to the rise of agency theory and the shareholder value model of the corporation. Those changes helped reduce the importance of the "managerial business model"—in which returns are generated through productive activities overseen by professional managers—and facilitated the emergence of the financial business model in which companies are viewed as assets to be bought and sold for the sole purpose of maximizing profit. We trace the history of the private equity business model, which took shape in the leveraged buyout movement of the 1980s, reemerged in the late 1990s, and expanded dramatically in the mid-2000s.

This new model of ownership and control poses a challenge to the conventional understanding of the nature of work and employment relations in modern capitalist economies. Most research on management, organizations, and employment relations draws on a concept of the corporation as it operated under "managerial capitalism." This model assumes that management strategies and control of labor and the production process are the keys to creating and extracting value in nonfinancial corporations. In a financial business model, by contrast, value creation and extraction occur through a wider variety of financial and operational mechanisms inside and outside of companies that affect workers in their roles not only as producers but as customers, taxpayers, and community members. This financial business model, as exemplified by private equity, requires a reexamination of assumptions about the nature of the corporation and the capital accumulation process and an exploration of how and why these changes alter the management of productive enterprises.

In chapter 3, we turn to a detailed description of the private equity business model and how PE firms and their investors make money. We present the classic or "generic" model, while recognizing that PE firms do

Figure 1.1 The Structure of Private Equity: Firms, Funds, and Portfolio Companies



Source: Adapted from Watt 2008.

vary somewhat in their strategies and incentive structures. It is particularly important to recognize that the PE model is multilayered, operating at the level of the private equity *firm,* the *funds* that it sponsors, and the portfolio *companies* that the funds buy (see figure 1.1). At the firm level, private equity is typically structured as a limited liability partnership that in its operations resembles a diversified conglomerate but with centralized control of legally separate portfolio companies; this structure reduces the legal liability of the firm and its funds for the companies in the funds' portfolios. With the portfolio companies of most private equity firms located in many different industries, private equity's expertise is typically financial, not operational. It takes advantage of economies of scale and market power and focuses on maximizing shareholder value at the level of the *PE firm* across all of its funds and portfolio companies.

At the level of the fund and its portfolio companies, private equity adopts the precepts of agency theory, which argues that concentrated ownership, the use of high levels of debt to discipline expenditure decisions, and managerial pay tied to shareholder value allows shareholders to monitor managers and better ensure that they act in the shareholders' best interests. But the PE model takes the idea of "concentrated shareholders" to the extreme by linking ownership more tightly to control: the general partner of the private equity fund decides which companies to acquire, sets the strategic direction for those companies, typically appoints members to the portfolio company's board of directors, and is also a member of the board himself. Executives of portfolio companies are handsomely rewarded if they meet performance targets set by the GP—and quickly dismissed if they fail. The investors, or limited partners in the PE fund, who are shareholders of each of the portfolio companies the fund owns, have little or no influence over which companies are acquired or how they are managed, but they may enjoy benefits not available to shareholders in publicly traded companies.

Our case studies show how this concentration of ownership and control allows the general partners to make money through financial engineering strategies that substantially increase the level of debt in portfolio companies as well as through business and operational strategies that reduce costs or add value to the enterprise. The relative mix of strategies depends importantly on the focus of the PE firm and the size of the portfolio company. Small and midsize companies, with enterprise values of under about $300 million, offer less collateral for leveraging debt and better opportunities for operational gains. Larger companies that already have professional managers and sophisticated systems in place, especially those with enterprise values over $500 million or $1 billion in value, offer fewer easy opportunities for operational improvements but have more assets that can be used as collateral to support high levels of debt. These larger companies offer more opportunities to use tax arbitrage, sell assets, cut costs, outsource operations, and access junk bonds for additional dividend distributions. In the years leading up to the 2007 financial crisis, private equity firms also made a lot of money by simply buying low and selling high, riding a rising stock market and the overall increase in the prices of operating companies in the bubble economy.

The financial crisis, however, undermined many of the assumptions of the classic private equity model, as we discuss in chapter 4. The high leverage that was critical to outsized earnings in good times left many PE-owned companies in financial distress when the economy contracted.

And while bankruptcies increased for publicly traded companies during the crisis, they skyrocketed for those owned by private equity because of the larger debt load they carried. And because exiting companies became harder, PE firms held on to companies longer than their three- to five-year targeted time frame. Fund-raising for new investments was also more difficult, and banks were less willing to make loans. As it became more difficult to find "good" companies to buy, PE firms ended up with unspent funds that the limited partners had already committed (known as "dry powder").

The poor performance of funds, slower exits, excess dry powder, and continued payment of management fees in the years following the financial crisis led to dissatisfaction among the limited partners. Private equity firms coped by devising a range of strategies. They refinanced many of their loans through "amend and extend" agreements; relied more on management fees than profits from the sale of their companies; and made greater use of dividend recapitalizations, loading portfolio companies with more debt in order to pay dividends to themselves and their limited partners. They made greater use of secondary buyouts—one PE firm selling a portfolio company to another PE firm. And they diversified their asset base by seeking funds from new investors, such as Sovereign Wealth Funds, while at the same time chasing new investment opportunities in emerging-market economies. Investments in distressed companies, which generally represented only 1 or 2 percent of PE investments prior to the crisis, increased somewhat during this period.

In the postcrisis period, many private equity firms tried to shift their emphasis to operational strategies. Given the difficulty in closing mega-deals, which had been much easier to pull off in the bubble years, they turned to the middle market. The middle market for private equity buyouts, however, is as amorphous as the middle class in U.S. politics. Deals valued at anywhere between $25 million and $1 billion are classified as the "middle market."

In chapter 5, we disaggregate the middle market into different segments and examine how differences in the size of private equity firms and the deals they make are associated with differences in the relative use of operational and financial engineering strategies. The classic large PE firm uses its financial skills for competitive advantage and focuses on maximizing short-term efficiencies to produce outsized returns. Smaller PE firms with fewer assets may be viewed as niche players with somewhat longer time horizons. They tend to buy smaller companies and to specialize in particular industries or areas of expertise. Opportunities for operational improvements are greater and collateral for leverage is lower in companies valued at less than about $300 million. In addition, banking deregulation has led to a consolidation of banks into large banks and "mega-banks" that are less likely to provide credit to small and midsize companies. Private equity has filled this vacuum, often combining financing with access to management and industry expertise. Here the PE general partner can establish a strategic direction, provide resources for operational improvements and expansion of the market to a regional or national level, and help the company grow. Our cases also show that making private equity pay off in this segment is difficult because PE firms cannot rely on high levels of debt to boost returns; they also need deep industry knowledge to set the strategic direction of the company and guide operational and marketing improvements. While these strategies are more common among PE firms operating in the middle market, we also found many examples of private equity failures due to mismanagement or a cookie cutter–like reliance on financial engineering.

In chapter 6, we assess the evidence on private equity fund performance and the returns to limited partners, net of management fees, expenses, and carried interest. Because there is no publicly available or comprehensive data on private equity, all studies of performance suffer from incompleteness and biases, and different methods of calculating returns yield different results. That being said, some data sets and methodologies are more credible than others. Reports that PE funds substantially outperform the stock market come almost entirely from industry sources, and these reports use the internal rate of return as the measure of performance. This measure is deeply flawed for several reasons, including the fact that it is an absolute rather than a relative measure—it does not take into account the alternative uses of funds that might generate higher returns. More rigorous academic studies compare the returns achieved by private equity relative to one or another stock market index. Here the results are far more modest: Although top-quartile funds do provide outsized returns, most pension funds and other investors do not have access to these PE funds. The top-quartile performing funds are largely accessible only to the large institutional investors with deep relationships with the leading PE firms. The returns earned by the majority of PE funds do not compensate limited partners for the added risk and illiquidity of PE investments.

Our review of the academic research covers the most credible studies by top finance scholars, who in the main do not rely on the internal rate of return to measure PE fund performance. Some studies report that the median private equity fund does not beat the stock market, and others show that returns for the median fund are only slightly above the market. The most positive academic findings for private equity compare its performance to the S&P 500: They report that the median fund outperforms the Standard & Poor's 500 by about 1 percent per year, and the average fund by 2 to 2.5 percent. The higher average performance is driven almost entirely by the top quartile of funds—and particularly the top decile. With the exception of the top-performing funds, returns do not cover the roughly 3 percent additional return above the stock market that is required to compensate investors for the illiquidity of PE investments. When PE funds are compared to indices of smaller publicly traded companies whose size is comparable to most PE-owned portfolio companies (the S&P 500 comprises much larger corporations), then the average PE fund barely performs better, and the median fund just matches stock market returns.

Our case studies also show the range of effects that private equity can have on the level of employment in the companies they own, a theme we turn to in chapter 7. Private equity typically acquires companies in which employment is growing. It has both created jobs through operational improvements and growth strategies and destroyed jobs via the closing of establishments, across-the-board cuts, downsizing, and outsourcing. Private equity's overall impact on U.S. employment is the net effect of job creation and job destruction, but it is difficult to construct national data to assess this question. We examine the small number of rigorous econometric studies using credible data that have been undertaken. Overall, these studies show that PE-owned companies destroy more jobs than they create relative to comparable publicly traded companies. In addition, these studies find that private equity firms tend to acquire healthy, better-performing companies rather than those suffering financial distress. That is, job loss in PE-owned companies is not due to the fact that these companies were distressed to begin with.

The union strategies of private equity firms are varied and complex, as demonstrated in our case studies across a wide range of industries and unions, from steel and autos to aerospace, food distribution, utilities, and hospitals. While some PE firms market themselves as union-friendly, others are hostile, and still others are agnostic. Their range of attitudes does not seem to differ substantially from those of U.S. employers more generally. Their control of employment relations is evident in the prominent role they have played in collective bargaining negotiations with unions. In some cases, negotiations between private equity owners and unions are constructive and produce positive outcomes for all parties, while in others, despite constructive relations, the leveraged debt model of private equity has left the company in financial distress, facing bankruptcy or a questionable future. In other cases, new PE owners have deunionized plants, while in still others unions have successfully mobilized against new owners and achieved successful contracts and more positive labor-management relations. What ties private equity employers together is their determination to extract higher-than-average returns compared to public corporations. For union workers, this often means giving up wages and benefits that they have fought hard to win and maintain. And in some cases, PE owners may be behind a portfolio company's decision to resort to bankruptcy courts and shift pension liabilities to the Pension Benefit Guarantee Corporation (PBGC).

U.S. unions have positioned themselves in a contradictory and complex relationship with private equity. On the one hand, PE owners often increase their returns by reducing head-count or wages or by jettisoning pension benefits for workers in the companies they control—a pattern we observe in chapter 7. On the other hand, public-sector and union pension funds have increasingly invested in private equity funds and now represent more than one-third of all investor commitments—the subject of chapter 8. In both cases, whether representing active workers or pension fund beneficiaries, unions are in an asymmetric relationship with private equity firms, which are in a more powerful position to dictate the terms of the agreements with unions. As limited partners in PE funds, pension fund trustees commit to invest in a fund for a period of ten years, during which time they typically pay an annual 2 percent management fee, but as previously mentioned, they have no say in investment decisions and may receive insufficient information regarding how decisions are made. This insufficient transparency in PE decision-making puts particular pressure on pension fund trustees to carry out due diligence and ensure that the PE fund is acting in the best interests of its current and future beneficiaries. We conclude by evaluating whether a series of reforms proposed by the Institutional Limited Partners Association (ILPA) are sufficient to improve the bargaining power of limited partners and their ability to act in the best interests of their fund participants.

In the final chapter of the book, chapter 9, we consider the role of public policy in reining in the excesses of private equity firms. In general, the financial engineering practices of PE firms are legal. Yet they may compromise the competitiveness of companies or even lead to financial distress or bankruptcy, eliminating jobs and pension benefits for workers and retirees. The policies we consider would retain the ability of private pools of capital to invest in and support the development of productive enterprises, while limiting the practices that undermine company sustainability and jobs. Our policy proposals would reduce the incentive to overburden portfolio companies with debt; improve transparency for limited partner investors; protect vendors, suppliers, and other unsecured creditors against the reckless transfer of portfolio company resources to PE owners; help ensure that PE firm partners pay their fair share of taxes; and update laws passed by Congress to protect workers so they take account of this new form of corporate ownership and governance, in which investors not only own but actively manage their portfolio companies.

In sum, private equity has emerged as a new financial player in the last forty years. Its business model represents an extreme form of the shareholder value model of the firm, substantially different from the business model of public corporations because of the moral hazard that is embedded in its approach to generating high returns. PE firms have benefited from lax regulation and a tax code that privileges debt over equity while the risks they take in pursuit of outsized profits affect the economic outcomes of thousands of companies employing millions of workers across the U.S. economy. The effects of their actions extend beyond the portfolio companies they own to suppliers, creditors, consumers, and communities.

In this book we document the investment and management activities of private equity, both where it has provided resources for operational improvements and growth and where it has extracted value at the expense of other stakeholders. We summarize the evidence regarding the economic returns to investors, the employment outcomes for workers, and the dilemmas for pension fund managers. Our policy discussion is meant to inform current debates and provide a roadmap for strategies to encourage the positive role of private pools of capital in the economy while constraining the moral hazard that leads to more negative results. Given the substantial and ongoing influence of private equity in the U.S. economy, it is in the interest of the general public, policy makers, and social science researchers to understand how the private equity business model works and how these investors have become managers.