Global business and private equity strategies: current challenges to labor

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In the last two decades, the private equity buyouts as an alternative investment reveal the strategies that have been adopted to guarantee high returns founded on market mechanisms. The leveraged buyout business model of the private equity firms, as the main agent for mergers, has both evolved from and fed a broader process of increased financialisation of corporate behavior and economic activity. This paper presents an analysis of the labor challenges as a result of the private equity firms’ management model focused on financial engineering. After a brief overview of the private equity buyout investments, we discuss the labor challenges in order to highlight the growing inequality between the worsening working conditions compared to the enrichment of the private equity partners.

Keywords: Business, Private equity Strategies, Labor.

INTRODUCTION

In the last two decades, the private equity buyouts as an alternative investment reveal the strategies that have been adopted to guarantee high returns founded on market mechanisms. The leveraged buyout business model of the private equity firms, as the main agent for mergers, has both evolved from and fed a broader process of increased financialisation of corporate behavior and economic activity. While finance is supposed to be assisting the real economy of goods and services, yet we see a relative decline in real investment, and in some OECD countries the share of wages in the national income is at its lowest level since the Great Depression (IUF, 2007).

It is necessary to apprehend these investment trends in the context of a social and economic system where the structural dynamics has created new arrangements between capital and labor. Private equity firms have been responsible for the employment standards of tens of millions of workers worldwide in 2007. The impact of
The growth of the private equity firms has been quickly becoming global voracious acquirers of assets (Dixon et al., 2007). Organized private equity in the United States has preceded its European and Great Britain counterparts. However, their scale and diversification now fully match their American counterparts (Tannon and Johnson, 2005). The British Venture Capital Association, for example, calculated that in Great Britain, 1 of every 5 employees was working for a company owned by private equity (BVCA, 2005).

This paper presents an analysis of the labor challenges as a result of the private equity firms’ management model focused on financial engineering. Our concern relies on private equity firms’ buyouts that have not only defined new parameters to attractive investment decisions but also fed the credit and capital market’s expansion. The interrelations among private equity firms, banks and workers reveal the adjustment of the social dynamics to the reorganization of markets and companies. Along with these changes, new perspectives on social reproduction have been driven by high leverage, short-term profits and competition. What the leveraged buyout model introduces is a high risk combination of leveraged debt financing with a short-term intent to resell the business in order to extract extraordinary returns (Klier et al., 2009). Without protections negotiated by trade unions through collective bargaining, higher returns can come at the expense of good jobs, secure pension plans, investments in upskilling and training of workers. This business model has relevant impacts on the economy, taxation system, government revenues, social security and employment conditions and security for employees (Tate, 2007).

First, we give a brief overview of the private equity buyout investments. Secondly, we discuss the labor challenges to understand the redistribution and reallocation of power and wealth because of the growing inequality between the worsening working conditions compared to the enrichment of the private equity partners.

**Investment buyouts**

In the last two decades, changes in the nature of wealth have been related to new articulations between financial and investment flows. The planning horizon is becoming shorter and the returns on investments are prioritized above real economic performance. The change in the
way investments is made, in how companies operate and in what kind of strategic planning is predominant in large parts of the business is intimately linked to the continuous growth of private equity and hedge funds – also called the new drivers of globalization (ITUC, 2007).

Private Equity funds have grown from a small participation in the financial market in the early 1980s to an important driver of financial globalization today. In 2005, for the first time, more money was invested into private equity than into stock mutual firms. In 2007, Morgan Stanley estimated that 2,700 private equity funds represented 25% of global mergers and acquisition activity and 50% of leverage loan volume (Jensen, 2007). Workers are confronted with over U.S. $1 trillion in concentrated buyout power (IUF, 2007). Of the top 50 private equity firms, accounting for U.S. 1.2 trillion of the U.S. $1.6 trillion in deals since 2002 up to 2007. Private equity funds are estimated to having spent some 600 billion US$ in 2006 on acquisitions of businesses, almost doubling their activities in 2005. In 2007, Great Britain accounted for 40 percent of all European private equity deals, and is second only to the United States. They expanded their share in the global M&A market to 25% before the crisis.

In the first stage, a private equity firm creates a private equity fund and obtains commitments from investors (limited partners) to provide capital to its fund. Later, when the firm undertakes buyouts, it calls on the investors to provide the capital. In particular, private equity fund centralize endowments from public and corporate pension plans, foundations, insurance companies, and wealthy individuals in order to assume a key role in the dynamic of investment buyouts. In the second stage, the private equity firm identifies potential companies for its fund to acquire. In the third stage, the private equity firm obtains a loan commitment, typically from commercial or investment banks, that it then uses to help finance its fund’s acquisition of the target company. A loan commitment is a promise from the lender to make available in the future a specified amount of credit under specified terms and conditions. Loans are an essential component of an LBO because private equity firms typically contribute through their funds only a fraction of the capital needed to complete the deal. In the fourth stage, after the buyout of the target company, the private equity firm seeks to increase the value of the company, so that the private equity firm can sell the company (fifth stage) at a profit and earn a return for its fund investors. Private equity funds typically hold an acquired company from 3 to 5 years before trying to realize their return. A private equity fund typically has a fixed life of 10 years, generally giving the private equity firm 5 years to invest the capital raised in its fund and 5 years to return the capital and expected profits to its fund investors.

Private equity firms are a financial phenomenon (Cullen and James, 2007). Equity firms multiple investors have assumed an active role in the selection of investments of high profit potential and in the process of fundraising. They use a combination of equity and debt to access private pension firms, insurance companies and endowments to invest in companies that are not traded publicly. The Uni Global Union survey, that covered the largest 116 pension funds in the UK, Continental Europe, Japan, Australia and South Africa, shows that pension fund private equity allocations vary: almost half of the funds allocate less than 2% to private equity, another 35% allocate between 2% and 4%, 16% allocate more than 4% (Uni Global Union, 2008). The highest average allocations were found in the Netherlands, UK and Sweden. However, in all these markets the average allocations were well below the average exposure for US pension plans, as much as 25%.

Under the private equity firms’ governance, the private sector companies’ asset management has privileged mobility, liquidity and great performance incentives based on high levels of debt. Academic research generally suggests that recent private equity LBOs have had a positive impact on the financial performance of the acquired companies, but determining whether the impact resulted from the actions taken by the private equity firms versus other factors is difficult to assess.

Regardless the differences observed in the organizational structure and post buyout actions, the social impacts of the private equity firms’ actions are relevant due to the adjustment of working conditions to investors’ targets. Similarly, a recent study estimates that private equity firms do not earn their income primarily by enhancing the value of their companies. The study, based on one large investor’s experience with, among other investments, 144 private equity buyout funds, estimated that private equity firms earned about twice as much income from management fees as from the profits realized from acquiring companies (Metrick and Yasuda, 2007).

Buyout investment decisions must be analyzed in a context of capitalist speculative finance where the accumulation of private wealth is the finality of the private equity investors. Assets, debts, cash flows, mergers and acquisitions overwhelm the investment decision process where the companies are viewed as a set of assets in which operation divisions may be bought or sell in order to pursue short-term profits. The portfolios of product lines follow the same rule. In a private equity firms’ portfolio structure, a company acquisition (investment buyout) is equivalent to an addition to a stock of financial assets and the investment buyout demand is generated by expectations on the extraction of short-run cash-flows. While uncertainty and financial markets affect portfolio possibilities and preferences, the private equity firms’ demand for already existing companies depends on the expectations about short-run flows of expected returns. In other words, the private equity buyout investment is anchored on the productive sphere but preserves liquidity. The exit conditions reveal the search for capital
Table 1. Leverage Ratio announced, U.S. acquisitions (more than US$100 million from January, 1, 2005 to September, 12, 2007)

<table>
<thead>
<tr>
<th>Private Equity Firm</th>
<th>Leverage Ratio</th>
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<tr>
<td>Madison Dearbon Partners</td>
<td>11.8</td>
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<tr>
<td>Providence Equity Partners</td>
<td>11.0</td>
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<tr>
<td>Blackstone Group</td>
<td>10.6</td>
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<tr>
<td>Thomas H. lee Partners</td>
<td>10.3</td>
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<tr>
<td>Carlyle Group</td>
<td>9.6</td>
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<tr>
<td>Goldman Sachs Group</td>
<td>9.5</td>
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<tr>
<td>Apollo Management</td>
<td>9.1</td>
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<tr>
<td>TPG</td>
<td>8.2</td>
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<tr>
<td>Bain Capital</td>
<td>7.8</td>
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Source: Bloomberg (2007)
Note: Average amount of debt committed to an acquisition relative to the target’s EBITDA.

mobility.
Taking into account this background, the typical private equity buyout firm (or LBO funds)

“… will present a business plan for a newly-acquired company characterized by cost reduction and management incentives in the form of significant management equity participation. Compared to other private equity funds, LBO funds tend to be quite large. Many funds operate with several hundred million or a few billion dollars in available capital.” (Tannon and Johnson, 2005:78).

Takeovers by private equity funds have also been shown to have negative consequences on national taxation systems. Authorities have therefore found evidence that private equity funds are also a sign of more aggressive tax planning. The fact that a vast majority of funds is based in tax havens obviously adds another blow to already declining public income from corporate taxation. The returns on investments, that many private equity funds are seeking, generally achieve 15-20 % a year (ITUC, 2007).

The total loss of capital invested is even close to zero for private equity buyout investors. Although their portfolio is related to existing companies, their performance is not dependant from the evolution of the good and services market as the private equity firms get a cash flow of anticipated dividends soon after the buyout transaction. Besides the payment of no –equity based fees, a higher debt ratio to improve short-term cash flows could increase the private equity firms’ investment returns before selling the portfolio companies three to five years later, either publicly or to another investor.

In truth, private equity firms turned out to operate as holding companies in a setting of mergers and acquisitions where they articulate business in different markets on behalf of financial engineering practices. The concentration and diversification investment trends, inherent to holding companies, characterized the private equity firms’ expansion. Their strategies, founded on the centralization and leverage to promote investment diversification have been favored by global liquidity.

In this scenario, market liberalization has fostered private equity investments through the business cycles. Kaplan and Schoar (2003) pointed out that market entry in the private equity business is cyclical. Taking into account the effects of the global financial recession on private equity firms, Peterman and Lai (2009) estimated that the private secondary market has grown from about U.S.$ 4.4 billion in 1997 to about U.S.$ 63 billion in 2007. In other words, the activities related to buying and selling private investor commitments in private equity and other alternative firms have increasingly been considered as a portfolio optimizing/management tool. While buyers see the secondary market as an opportunity to access selective firms or diversify portfolios- often at discount prices- , potential sellers view it as a source of liquidity and exit. Both buyers and sellers’ decisions aimed to get quicker returns in the secondary market. This performance is not dependent on the stock market as the portfolio companies are usually non traded in capital markets.

In this setting, the relations among private equity firms, portfolio companies, banks and workers turned out to consolidate the actions of new social actors and also reveal the growing flexibility of the social dynamics. Short-term expectations turned out to be evident in such investments. Their finance-led management practices threaten the sustainable business development in terms of cash flows, research and innovation. But short-termism and the consequent drive for higher returns also leads to downward pressure on wages and working conditions (ITUC, 2007).

Private equity firms and labor
Some academics view such leveraged buyouts as revolutionizing corporate ownership by creating new
funding options and corporate governance structures, as well as by providing investors with attractive, long-term investment opportunities. However, some labor unions and academics have a less favorable view—criticizing leveraged buyouts for harming workers, such as through job losses and lower benefits; providing private equity fund managers with, in effect, a tax subsidy; or burdening companies with too much debt.

Jensen (1989) points out that takeovers, leveraged buyouts and other going-private transactions, like the private equity firms, are manifestations of the emergence of new organizations where resources could be managed more effectively than in public corporations. Under the investors’ perspective, private equity firms improve performance of their portfolio companies after the takeovers. On behalf of the higher levels of debt, managers have to increase operational returns in order to focus on regular payments to debt holders. The presence of private equity investors in management and succession planning is also considered a strategic orientation for increasing future returns.

However, Montgomerie (2008) assessed that private equity firms’ buyout strategies limit growth and prevent long-term investment. In fact, equity firms’ acquisitive expansion has been highly leveraged and, as a result, fostered market consolidation and capital concentration in different kinds of business in the global context. The private equity investors’ ability to couple debt and equity could have a relevant role to acquire control of underperforming corporations and expand the control over the means of production. Consequently, they have been active in the buyout market and the employment trends have been subordinated to ownership changes, financial restructuring and company efficiency. In truth, the degree of monopoly and the productive capacity in a variety of companies and industries, besides the working conditions, have been constantly reorganized and reconfigured after the takeovers.

Private equity investors are less interested in the use of value of production; rather their target, as the personification of capital, is the expansion of value. In this setting, liability management enhances the expansion of debts. A leveraged buyout differs fundamentally from a traditional merger or acquisition in two important ways. First, the acquired company pays the cost of its own acquisition through debt and fees (Table 1).

Secondly, the private equity investor is necessarily aggressive in pursuit of such profits. These two elements are central to the leveraged buyout process and pose particular challenges to unions when engaging and bargaining collectively with private equity portfolio companies. Generally, the potentially adverse restructuring impacts of leverage buyouts on workers tend to increase the higher the targeted return on investment, the more leveraged the deal, the faster the withdrawal of equity and the shorter the period before exiting the investment (IUF, 2007).

The credit flows to the private equity firms’ portfolio companies is a key issue in the apprehension of the “rationalization” of companies and the reorganization of the good and services market. In fact, the credit expansion could turn out to disorganize traditional markets where the social tensions augmented on behalf of the restructuring impacts of the higher debt. As the rationalization adjustment process is not implemented by the investors, the performance targets and debt repayment put pressure on the management organizational practices.

The private equity firms have come to view their companies in terms of their short-term financial performance while the managers are under pressure to produce results quickly. The Workers’ Guide to Private Equity Buyouts summarizes the short-term investors’ perspective:

“The short-term, unsustainable system of dividend recaps perfectly illustrates the logic of private equity buyouts. Private equity firms buy a company as a financial asset with the potential to generate an instant cash flow to the new owners in the short term. Huge returns are generated through aggressive restructuring to cut costs and by financial reengineering based on large quantities of debt” (IUF, 2007:10)

As a result, private equity investors’ returns are independent from the portfolio companies’ performance (Montgomerie, 2008). Private equity firms represent the development of new forms of business model that challenges the “enlightened shareholder value model”;

“Enlightened shareholder value is based on the assumption that in the long term there is a convergence of interests between shareholders, employees and other stakeholders. However, the private equity model often pits the short-term interests of private equity owners against the long-term interests of employees and other stakeholders. The new directors’ duties are insufficient protection against directors of private equity owned companies taking decisions that are not in the interests of the company in the long term. The growth of private equity exposes the flaws of enlightened shareholder value principles” (Montgomerie, 2008:10).

The growth of these new financial actors has contributed to the redefinition of labor relations because the investors subordinate the accumulation dynamics to a model of business that is not committed to corporate governance guidelines, social responsibility or decent work. The logic of buyout investment of the private equity firms reinforced the subordination of social life. The changing working conditions result from
“….continuous restructuring to generate cash outflow, falling levels of productive investment. Institutionalized short-termism, increased outsourcing & casualization to cut costs, sell-offs & closures regardless of productivity & profitability; deteriorating working conditions; diminished employment security, invisible employers” (IUF, 2007:17)

After the takeover, the generation of cash flows to pay non–equity based fees, anticipated dividends and debts require growing cost reductions with decisive effects on labor relations, employment trends, social benefits and unions’ actions. Consequently, the reorganization of the production reshapes tasks and the control of workers in a context characterized by turnover, outsourcing and casual work. The results of the “rationalization” process are conditioned by the level of monetary wages, the workers’ skills and abilities, the diversity of labor contracts and collective organization. The new trends in labor contracts and collective demands reveal the changing working conditions that are characterized by the “invisibility” of the investors (capital).

Thus, the private equity firms as a financial phenomenon express the power of centralized money to define investment flows with attractive returns and liquidity. The portfolio model of the private equity firms expresses the potential conflicts between the investor and the portfolio company management (Hill and Gambaccini, 2003). As the management commitment relates to the payment of debt, the company turns out to be subordinated to efficiency targets that shape labor relations overwhelmed by longer working hours, job destruction, turnover, outsourcing, workforce displacement and lost of rights.

Montgomerie (2008) gives outstanding examples regarding the changing working conditions in Germany and the UK. Management used operating cash flow to repay the debt, leading to a decline in investment in research, development and new capital equipment. Labor turns out to be the main focus of cost saving measures, first through longer working hours, then the abolition of holiday pay and finally through the reduction in the workforce and worker displacement.

Beyond the “rationalization” strategies, the social conflicts and tensions are strengthened as the flexibilization of labor relations need to be adjusted to the private equity investor needs: capital mobility and short-run returns. Davis et al. (2008) conduct an analysis covering information regarding US buyout operations between 1980 and 2005 and also find that private equity firms’ targeted companies exhibit net employment reduction and higher job destruction. Using a sample of 48 UK buyouts, Cressy et al (2007) found that leveraged buyouts bring about quick and substantial reductions in employment in target companies during the period of “rationalization”. Furthermore, increases in turnover as profitability and sales expand for more than 3 years could be responsible for the reversal in job creation by the year

5. The research results of Harris et al. (2006), which contains longitudinal data for approximately 36,000 U.K. manufacturing establishments, imply that after management buyouts, the improvement in economic performance may be due to the measures undertaken by new owners or managers to reduce the labor intensity of production, through the outsourcing of intermediate goods and materials.

Thus, the employability conditions have been decisively affected by financial strategies stimulated by the private equity firms (IUF, 2007). The consequence is an uncertain future for the company and its workers. The short-term strategy employed by private equity investors (3-5 years) is obviously a threat to sustainable company growth and investment in the form of research, development and innovation. The constant drive for short term financial returns also creates a situation which leads to downward pressure on wages and working conditions. This means where jobs are not immediately lost they can end up as work of low quality, and low pay (Amicus, 2007).

CONCLUSION

At the heart of our argument is that the capital accumulation process involves social relations driven by profit and competition. As the private equity investors’ motive is not growth per se but value extraction, the social losses in terms of unemployment, working conditions, workers’ rights and income distribution could be relevant: “Short-termism is institutionalized at the workplace and in society “ (IUF, 2007:24)

The current global financial scenario suggests a new articulation among liquidity, investment and labor beyond the reorganization of business and markets under private equity investors’ actions. The analysis of the financial management model of private equity firms has revealed the challenges to social reproduction in contemporary capitalism on behalf of the increasing social vulnerability

Banks can enlarge the purchasing power of money and, consequently, stimulate the private equity firms’ portfolio companies with conventional credit operations. In truth, the companies’ leverage favors the short term returns of the private equity firms and reinforces the speculative nature of credit. In this setting, the investment flows and organization of production is subordinated to the evolution of expected future returns and exit conditions of private equity firms’ investors and banks. Nevertheless, all the loans are burdens on the actual operating company and increase the companies’ debt, leading in many cases to insolvency. As a result, the portfolio companies are more vulnerable to economic downturns. In many cases, the operational results have stimulated new waves of buyouts, nurtured by the private equity holdings. In fact, private equity deals are mostly done to achieve the expected short-term performance.
In this scenario equated by banks and investors, the workers have no defense. For workers, the declining rate of real investment has meant that productivity is boosted in the short-term by extracting more with less; reducing payroll and increased reliance on outsourcing and casualization, which creates long chains of precarious labor (IUF, 2008). Outsourcing, subcontracting, the substitution of temporary for permanent jobs, consolidation of operations and supply chain restructuring have exacted heavy tolls on workers and communities (IUF, 2007).

There is no doubt that the buyout business is a major contributor to the concentration of wealth. A recent study by the World Economic Forum on the destructive job impacts of private equity buyouts simply confirms what unions have been saying for many years from direct experience - both the quantity and quality of jobs suffers under private equity ownership.

REFERENCES


