THE CHALLENGE OF PRIVATE EQUITY: DOES INSTITUTIONAL EMBEDDEDNESSMATTER LESS THAN WE THINK?

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Abstract

The purpose of the paper is to identify the impact of the Private Equity Business Model (PEBM) on comparative industrial relations in three ways. First, in the contemporary period of 'new capitalism' emphasis on institutionally governed resources, capabilitiesand markets may be become less authoritative methodologically. Whilst the belief systems and cultural values of business systems are generally less mobile across national boundaries, sources and methods of finance, investor knowledge, information and investor-owner management capability and engagement are mobile across international boundaries. This process, termed 'financialization', as current global financial crises bear witness, will continue to test established approaches to comparative analysis summarized as divergence. A second challenge centres on the capacity of comparative analysis to make a distinctive scholarly contribution when it is faced with, not only first order changes associated with financialization but in addition to this, the current global crisis. Here, as the paper details, a focus on 'disconnection' between system and firm level may enable researchers to identify the emergence of 'hybrid' sometimesdysfunctional tendencies in otherwise nationally distinct business systems. A third challenge relates to the importance of multidisciplinary scholarship and research in the evaluation of distributional and regulatory issues within business, human resource and industrial relations strategies. This requires critically informed academic analysis of interfaces that see private equity asa business model governing firms and a source of finance in the shadow banking sector.

INTRODUCTION, BACKGROUND & RESEARCH METHOD

The past ten years has witnessed significant growth in company buy-outs by private equity funds which increase the ratio of debt-to-equity giving rise to the term leverage buy-outs (LBO). These deals, have, since 2006, courted controversy about the potential impact they might have on the health of firms and employees, (FSA, 2006, Clark, 2007, TSC, 2007, GAO, 2008). Private equity is a pool of capital raised for the specific purpose of investing directly in companies. Funds are actively managed by plc fund management companies or limited partnerships which may control numerous funds. Limited partnerships are the favoured vehicle for the PEBM because they have no legal or taxable personality yet individual partners operate collectively. Therefore, fund managers (managing partners) and investors (limited partners) are taxed as individuals. Practitioners and some academics use the term narrowly to describe LBOs whereas others use it more inclusively to cover venture capital and mid-market buy-outs of private firms or orphaned corporate divisions. Whilst recognising the inclusive approach this paper focuses on 'public to private' or the 'take-private' private equity business model (PEBM). Therein larger, often multinational private equity funds, acquire listed firms or divisions of listed firms by buying a controlling percentage of shares on a publicly quoted stock market. Once a fund has control of all the shares in a portfolio company it becomesthe single shareholder and the firm is no longer a publicly traded plc company. These transactions account for 7% of all private equity dealsbut measured in $US they account for 28% of all firms acquired in the US whereas in sterling they account for between 20%-30% of acquisitions in the UK, (WEF:viii, 2008, Ernst & Young, 2008:7 and Gilligan and Wright, 2008:14)

Structural developments within new capitalism disrupt embedded patterns of relations between employers and labour in the American and British business system. Financial de-regulation together with market globalization has combined with the apparent dominance of a business model centred on delivering investor and shareholder value in capital markets. At business system level the short term imperative to generate revenue within new modelsof competitiveness emphasize investor and shareholder returns and disdain for customer, employee and exchequer interests to 'disconnect' more established circuits of capital which are embedded in national business systems, (Thompson (2003). The disconnected thesis was further developed by theorizing how the PEBM diffuses the imperative of investor-owner interests under new capitalism, (Clark, 2009). Within this process, accumulation strategies associated with investor-owners such as the PEBM disconnect evaluation of industrial relations as a broadly defined academic discipline, relegating its evaluation to an issue of outcomes and efficiency.

Taking disconnection as its cue the paper has three sections. One, the paper identifies that at system level private equity firms and the PEBM presume and promote isomorphism in business strategies and policies that prioritise investor interests in short term financial engineering. Rhetorically, at firm level investor interests and financial engineering each assume and promote diffusion of a new organizational form and associated business model with the potential to operate across market and coordinated business systems. Two, the paper identifies that potential pressures on the management of industrial relations that flow from this diffusion are both competitive as a new driver at system level and institutional, that is, in the extent to which and the manner by which, at firm level, system imperatives are accommodated. As an efficiency-based innovation the business model may appear too as a best practice template for firms which are not governed by private equity. Three, the paper identifies the distributive impact of the PEBM. Here acquisition by private equity may have a significant effect on industrial relations at firm level as employees become subject to tighter and more onerous technical and bureaucratic controls where a firm is downsized and slimmed to its core competences. In contrast to this at management level remuneration may be boosted by the diffusion of agency inspired performance management incentives.

Research Methods

This paper uses a meta-review research method which refers to a systematic evaluation of existing studies, both theoretical and empirical, supported by primary data collection from publicly available sources in the private equity sector, interviews with market experts and primary case study, interview and documentary research. Below and beyond a reliance on surveys of economic outcomes, as the name implies private equity, broadly defined, is a difficult asset class to research. Whilst literature reviews of empirical research on private equity appear to support the theory of efficient capital markets thesis that firms governed by private equity outperform plc firms, (for example, Gilligan and Wright, 2008) much of this work is sector led. Independently funded research both theoretical and empirical whilst it is now securing some movement was for much of the recent wave of LBO activity absent.

1. PRIVATE EQUITY & ISOMORPHISM IN ORGANIZATIONAL FORM AND BUINESS MODEL?

This section addresses the first challenge; the starting point for comparative analysis in distinct national business systems and stable patterns of managerial discretion and control over businesses. For some, a new capitalism, centred on global financial capital, has emerged and a focus on these financial institutions is critical because of the sustained impact they have across national boundaries, (Soros, 2008, WEF, 2008). Failure to evaluate the role, both direct and indirect, of global financial capital and its impact on distinct national business systems and related patterns of job regulation will render comparative institutionalism less authoritative than it currently is as a framework for scholarship and research. This is case because across business systems the evidence suggests that private equity firms and the PEBM prioritise investor interests in short term financial engineering, (Watt, 2007, WEF, 2008). Moreover, the recent past is awash with efficiency-focused practitioner-leaning research which in addition to this suggests that the PEBM out-performs plc firms in terms of job creation, innovation, productivity and employee relations practices, (CIMBOR, 2008, Lerner et. al., 2008). It is these presumptions which lead to the assertion that the PEBM promotes isomorphism in business strategies and policies not only within but beyond firms governed by private equity.

Isomorphism, Business Strategies and Organizational Form

Isomorphism describes the processes by which organizations are induced to adapt to institutional environments, in particular, the global diffusion of specific business strategies, (DiMaggio and Powell, 1983, 1991). A key conceptual and empirical issue relates to 'global diffusion' of managerial and organizational concepts subject to local variation, or the extent to which business strategies, practices and models become more similar on a global scale. Firms respond to demands for legitimacy with key stakeholders – investors and shareholders and in the contemporary period managers are either compelled or encouraged to adopt structures of external control that are in the interests of these stakeholders. The demands of investor and shareholder value are identifiable modalities or a method of procedure which lead firms to adopt similar structures or management tools.

The isomorphic inducement to adopt similar solutions in the same situation, for example shorter term pressures for investor returns operates at the level of the business system and the firm in coercive, mimetic and normative forms. However, firm level pressures are distinct from competitive isomorphism at business system level which necessarily assumes and requires the presence of more market oriented competition. Management beyond private equity backed firms may have to compare themselves to competitor firms in the same sector which are governed by the PEBM, leading to mimetic pressures to copy or benchmark against practices in these firms. In turn this may lead to normative pressures whereby practices associated with the PEBM are talked up as 'best practice' or prescribed by professional commentators or practitioners as competitive system level solutions for firms governed by a plc board, (for example, see BCG/ ISES:2008).

Isomorphism and Financialization

Competitive and institutional isomorphism highlight how unfettered transaction oriented finance is re-shaping the world economy, therein an increasingly 'dis-intermediated' banking system trades in assets rather than holding them for long periods of time. 'Financializaton' defines this re-shaping and illustrates four developments. One, how financial institutions and investors achieve returns unrelated to the production process, (Soros, 2008). Two, how financial demands increasingly dictate the behaviour of firms and change the basis of competitive rules, (Clark, 2009, Thompson, 2003:366. ITUC:7) Three, how volatility in defined financial markets has the potential to de-stabilize the real economy of a business system, including the labour market and patterns of job regulation at firm level, (Jacoby, 2008). The process of financialization makes it more difficult for firms in liberal and coordinated business systems to sustain costly governance structures that benefit stakeholders beyond investors and stockholders such as employees in well developed approaches to industrial relations or HRM. Four, a dialectic flows from the process of financialization. In a global system, financialization opens up external and methodologically alien sources of funding which firms may turn to in order to sustain embedded business and HR strategies. Financial instruments such as opaque off balance sheet investment vehicles often owned or funded by overseas private equity funds or sovereign wealth funds are readily available. Moreover, disagreement about 'who the company is for', when financialization dominates and the volatility that can come with this, is a core question in on-going debates on corporate governance and the relationship between preferred governance models and industrial relations frameworks, (see Allen, et. al. 2007). Pioneers of the corporate governance literature outline a pure agency perspective often referred to as separation of ownership and control, (Shleifer and Vishny,1997). This perspective becomes more significant to industrial relations scholars as diffusion of the PEBM in the USA, UK and across the EU is both real (10% of the UK and US private sector) and a mimetic and coercive best practice template for firms which are not directly governed by the private equity business model, (see for example, Acharya, Kehoe and Reyner, 2008:14-16). This section of the paper identifies a scholarly challenge which is methodological and observable; specifically, the capacity and capture of comparative analysis as a methodology for theoretical and empirical scholarship under new capitalism where finance and associated business models operate globally and indiscriminately.

2. FINANCIALIZATION, PRIVATE EQUITY AND INDUSTRIAL RELATIONS, Reviewing the Literature and Positioning Primary Research?

This section further addresses the capacity of comparative analysis to provide a distinctive evaluation of private equity and the PEBM in new capitalism. To this end the theoretical device of 'disconnect' between system and firm level is further outlined which will enable researchers to focus empirically on the emergence of contradictory tendencies for industrial relations and HRM in distinct business systems. These tendencies flow from business strategies associated with financialization, the PEPB and related isomorphic pressures, both competitive and institutional.

Advocates (Rappaport, 1996, Hansmann and Krackman, 2001, Gulger, et. al. 2004) and critics alike (Clark, 2009, Hutton, 2002, Singh et.al. 2005) are agreed that the American model for short term wealth maximization focusing an investor and shareholder capitalism subject to the discipline of financialization is triumphant, if problematic. In turn, hypothesises of this competitive focus lead contributors to the debate to conclude that globally defined competitive pressures which are diffused from the American business system, will at firm level, induce more firms across different business systems to converge on business, financial and HR strategies alien to indigenous businesses, (Carr, 2005, Gulger, et. al. 2004, Jacoby, 2005, 2008 and Pudulko, 2006). Financialization across, within and between business systems exposes categories of institutional difference in corporate governance and stakeholder interests including patterns of industrial relations. Within this exposure the associated diffusion of private equity, particularly those forms that support take private deals, increasingly identify that whatever the current position, the operating performance of a firm depends on a unitary alignment of owner, manager and employee interests. For many, this alignment rejects the utility of pluralist stake holding approaches to industrial relations even if this approach remains in place post buy-out, and in the UK private equity owner-managers have hired anti-union consultants to secure this position, (see Logan, 2008:18**).** Similarly, in Germany, private equity co-owners of Deutsche Telecom secured the transfer of previously un-sackable civil servants from a subsidiary that they now control. In addition to this they ensured that even though these workers are classed as private sector employees that the state underwrites all their pension payments. Alternatively, in the UK private equity owners have used de-recognition followed by re-recognition of a 'company union' to maintain pluralist relations in the workplace but on a 'lower road' model, (TSC/GMB, 2007). At business system level, the relationship between financial development and labour regulation formulated in agency theory provides the economic rationale for this is because in the contemporary period the concept of management rights refers to decisions that management reserves for itself free from union influence, (Logan, 2006:652, Jacoby, 2008:42). There is evidence that in internationally competitive, yet globalized, sectors such as car components, system level drivers and embedded institutional and cultural routines at firm level become contradictory and oppositional in German and Japanese firms because of systemic convergent pressures spurred by financialization. This pressure is in-direct and witnesses the emergence of 'global-professional' management practices measured on short term financial metrics associated with American and British firms which are subject to a more fierce market for corporate control. Following on from this decision styles and performance management metrics in business, financial and HR/IR strategies gradually became more consistent with the Anglo-Saxon model, (for a sector wider discussion of this process see Carr, 2005).

The emergence of new capitalism on a global basis which emphasizes investor and shareholder interests challenges the capacity of comparative institutionalism methodologically, intellectually and empirically. This second challenge is complicated precisely because the diffusion of new business practices is so fluid. This makes it unclear if diffusion centres on a convergent language for management rhetoric which is operationalized in convergent business and HR/IR practices at firm level or if the institutional frameworks of established pathways can accommodate diffusion of new practices rather than change to do so. Here a key scholarly challenge focuses on the difference between systemic competitive ismorophism and institutional isomorphism at firm level.

It follows from this that a systematic comparative evaluation of disconnects, (how practices associated with investor and shareholder value in the PEBM diffuse at firm level) requires an accommodative conceptual framework. The business system approach may be capable of this, (Whitley, 1999). The business system focus on resistance to change, sometimes referred to as determinism, could, in the face of new capitalism, be utilized to evaluate the speed of institutional diffusion at firm level and the visibility of this process, (recent contributions working in this direction include Morgan and Whitley, 2003:615, Whitley, 2003, Ferner, et.al. 2005, Tempel and Walenbach, 2007, Watt, 2009)

Theoretically, a clear disconnect exists in new capitalism between system level pressures, which highlight the economics of information and direct ownership interests, and the evaluation of institutionally embedded managerial capability and discretion at firm level. Empirically, this de-coupling will, across different systems, centre on the ability of owner-managers in firms governed by the PEBM to align the interests of owners, managers and workers on the basis of strategies and policies for management and industrial relations steeped in agency theory. Hence, the question at firm level for businesses governed by the PEBM centres on the residual claimant status of established stakeholders along side investor and shareholder stakeholders.

3. REGULATION AND DISTRIBUTION: THE IMPACT OF THE PEBM ON MANAGEMENT AND WORKERS AT SYSTEM & FIRM LEVEL?

In new capitalism the weightlessness of regulatory and distributional issues demonstrates the need for comparative industrial relations scholars to adopt a collaborative interdisciplinary approach. This means theorizing and writing laterally - beyond one particular line of inquiry, for example, institutionalized industrial relations and longitudinally, from a distance in other reference systems or disciplines such as corporate governance. Permissive regulatory frameworks in many systems have facilitated the use of management incentives designed to achieve immediate returns sometimes at the expense of worker interests broadly defined. Emphasising immediate investor and shareholder goals over longer term strategies, including those of wider stakeholders such as customers, employees and suppliers, disconnects management-owner defined interests from wider stakeholder interests. More significantly still, this approach gentrifies investor and shareholder value as a strategy when theoretically and empirically it is the result of wider efforts which generate supernormal profits or sales revenue maximization.

Empirically, a key point at issue relates to the insertion of agency perspectives on corporate governance, (how investors get management to give them their money back), within LBOs which are increasingly sponsored by the PEBM. Many acquisitions aim to generate investor and shareholder value by financial and governance engineering, for example by re-structuring the debt-to-equity ratio of a firm and changing management incentives in order to secure improved operations, cash flow and profitability. Evidence suggests that managers in firms which are governed by the PEBM face new managerial and control challenges because new 'growth improvements' cannot be sustained by organizational change alone and operational improvements to business, financial and HR strategies follow a financial measure of efficiency to value a firm termed EBITDA *(earnings before interest, taxes, depreciation and amortization)*. Therein, managers them selves, although incentivized, have to adapt to tighter performance monitoring in respect of more hands-on professional owner-appointed management overseers. Once acquired by private equity and subject to the PEBM managers reach an inflexion point where there is a recognition that they and the firm have to adapt to investor driven challenges which change the basis of competitiveness within portfolio firms, for example, where investment may be forthcoming but must make a return in less than five years. Much of the established material on LBOs broadly defined suggests only a marginal impact on industrial relations and HR, (Gilligan and Wright, 2008). There is, however, evidence to suggest that investment in learning and development and general industrial relations and HR expenditure is subject to significant scrutiny and may 'fall off a cliff' as a portfolio firm nears the exit phase.

Management reward, for example, share options, sweet equity and bonuses set against share price improvements, is designed to incentivize managers to achieve capital gains where budgets are tightly monitored against cash flow and defined performance metrics, (Gilligan and Wright, 2008:21-22). However, whilst the predominance of agency theory legitimizes a strategy of encouraging managers to act like owner-managers, managers remain employees who become part of the culture of monitoring and cost control. This often includes significant pressure on wages, benefits and working conditions and refusal to engage with established partners in collective bargaining, (ITUC,2007:5) Lateral and longitudinal thinking demonstrates that the distributional consequences of running a firm on the basis of the PEBM are in part subliminal and potential, but none the less provides a sharper focus on the distributional consequences of this model. This is the case because private equity not only provides a model for governing portfolio firms it manages loan models in the shadow banking system which has emerged since the early 2000s. For example, the securitized loan-model where banks parcel up loans secured against property and sell them to raise 'new capital'. However, as financial markets went into reverse in 2007 the distributional consequences of the PEBM became more starkly evident as the value of many portfolio firms became lower (as low as zero) than the loans that supported them pushing some firms into liquidation and others into severe downsizing mode.

The negative yet unfolding effects on workers of a free wheeling approach to finance and corporate governance look likely to reset new capitalism in a number of ways not least in attitudes towards pay inequality, employment insecurity and transparency manifest as wide spread public disenchantment with market liberalism in the UK and the USA. Regulation of business models that focus on investor and shareholder interests may better protect worker interests but is still at an early stage. The Obama administration has pledged to tax private equity profits as income not a capital gain a move that will improve transparency for workers, (Deloitte, 2008:5,11). In addition, the administration has proposed sweeping changes to labour market policies in an *employee free choice* Act to foster unionization which may too give workers in firms governed by the PEBM improved transparency and collective rights. In the UK neither legislative pledge has been mirrored. Private equity self regulation in the form of the Walker Review (2007) and reports by the associated guide lines monitoring group (GLMG) (2009) is the preferred route to voluntary self regulation. Notwithstanding this, the GLMG reported that a third of portfolio firms breached the voluntary code in 2007 and both the GLMG and Walker are decidedly silent on industrial relations issues, in particular transfer of undertakings protection in the case of acquisition by private equity. More alarmingly, the EU Commissioner for internal markets and services now appears to favour EU wide voluntary regulation on the Walker model and is rowing back from a previously avowed policy of pan-European legislative regulation, (EP,CEMA, 2008, IUF:2009). Similarly, the Turner Review (2009) on the global banking crisis is equally silent on employment issues, risk management systems, disclosure and 'whistle blowing' procedures for alerting management to unexpected problems and risks associated with complex financial instruments, particularly the misguided use of pension funds as collateralised or securitised loans. This section addresses the challenge that the diffusion of the PEBM poses for academic and scholarly analysis in respect of distributional and regulatory issues at firm and system level. In particular, it highlights the importance of a multidisciplinary lateral and longitudinal method capable of conceptualizing the PEBM to recognise that within a broad research problematic the academic and practitioner antecedents of the PEBM lie beyond industrial relations as an academic discipline but have a significant impact on industrial relations.

SUMMARY AND CONCLUSIONS

The purpose of this paper is to identify the impact of the PEBM on established frameworks for analysis in comparative industrial relations. The substantive sections of the paper address this challenge theoretically and empirically leading to three conclusions which are substantive but not empirically conclusive at this point in the research and scholarly process. One, institutionally governed business systems and cultural values grounded in distinct national processes at firm level are not insulated from the up-side or the down-side of new capitalism, investor and shareholder value and associated business models such as the PEBM as a system level driver. As a structural development the process of financialization disrupts and disconnects established divergent patterns of relations between capital and labour. The global economic and financial crises bear witness to the contemporary limitations of divergence as the effects of these crises are not limited to liberal market economies because all types of business system have engaged with new capitalism and the process of financialization. Two, the capacity of comparative industrial relations centred on the thesis of divergence at system level and the related country of origin effect at firm level is challenged by new capitalism at least at system level. The challenge at firm level is for scholars to recognize that the diffusion of private equity investment and the PEBM bring new research categories which must be integrated into established frameworks if they are to sustain academic integrity. For example, who owns a firm? what was and what is the country of origin of a firm pre and post-acquisition? and what is the firm for where new capitalism predominates over Anglo-Saxon, Rhineland or other variants of stakeholder capitalism. These issues are not only a challenge for those of us who ascribe to divergence but they spell danger too. Advocates of new capitalism and the efficiency credentials of the PEBM have a first mover advantage reminiscent of those associated with productivity and later high performance work systems where failure to engage conceded efficiency discourse putting industrial relations analysis of these issues on the back-foot. The subliminal isomorphic pressures associated with new capitalism are evident across business system types whereas these pressures on organizational form and business model at firm level are less evident but unresearched within and beyond firms governed by the PEBM. Three, new capitalism like established forms of capitalism includes many largely unregulated actors yet, the difference between old and new is that unregulated actors operate globally and beyond national frameworks of regulation for business and industrial relations. Regulatory and distributional issues disconnect and ignore industrial relations and employment issues broadly defined. In the UK investor-owners who utilize the PEBM can disconnect – break-up de-institutionalize established patterns of job regulation in several ways for example by selling pension schemes and managing them on a contractual basis, refusing to accept employer status and agreements with the workforce and transferring employees to loss making subsidiaries.

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