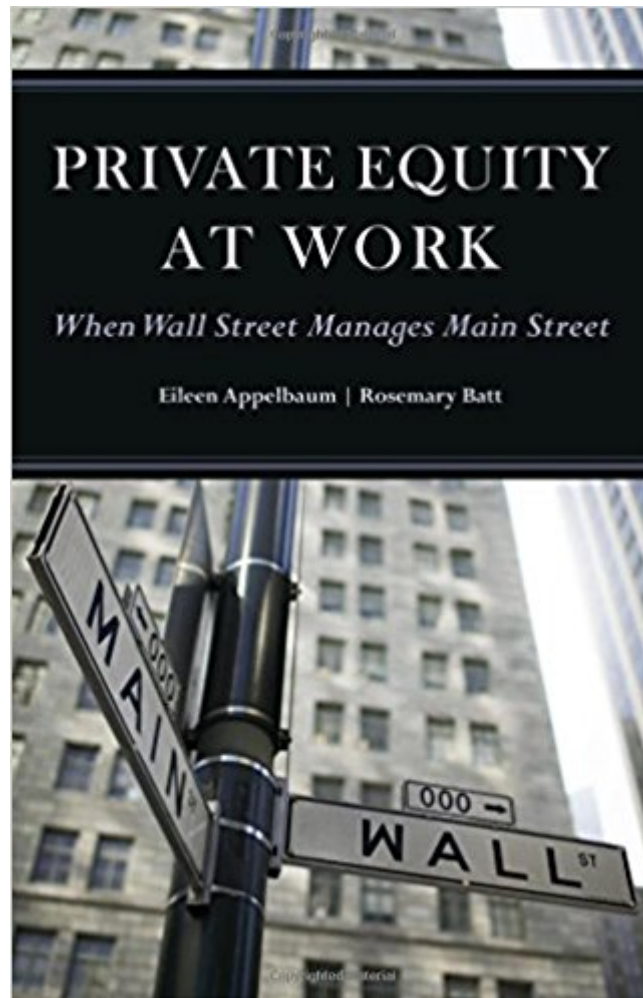




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Private Equity At Work: When Wall Street Manages Main Street



Synopsis

Private equity firms have long been at the center of public debates on the impact of the financial sector on Main Street companies. Are these firms financial innovators that save failing businesses or financial predators that bankrupt otherwise healthy companies and destroy jobs? The first comprehensive examination of this topic, *Private Equity at Work* provides a detailed yet accessible guide to this controversial business model. Economist Eileen Appelbaum and Professor Rosemary Batt carefully evaluate the evidence—including original case studies and interviews, legal documents, bankruptcy proceedings, media coverage, and existing academic scholarship—to demonstrate the effects of private equity on American businesses and workers. They document that while private equity firms have had positive effects on the operations and growth of small and mid-sized companies and in turning around failing companies, the interventions of private equity more often than not lead to significant negative consequences for many businesses and workers. Prior research on private equity has focused almost exclusively on the financial performance of private equity funds and the returns to their investors. *Private Equity at Work* provides a new roadmap to the largely hidden internal operations of these firms, showing how their business strategies disproportionately benefit the partners in private equity firms at the expense of other stakeholders and taxpayers. In the 1980s, leveraged buyouts by private equity firms saw high returns and were widely considered the solution to corporate wastefulness and mismanagement. And since 2000, nearly 11,500 companies—representing almost 8 million employees—have been purchased by private equity firms. As their role in the economy has increased, they have come under fire from labor unions and community advocates who argue that the proliferation of leveraged buyouts destroys jobs, causes wages to stagnate, saddles otherwise healthy companies with debt, and leads to subsidies from taxpayers. Appelbaum and Batt show that private equity firms' financial strategies are designed to extract maximum value from the companies they buy and sell, often to the detriment of those companies and their employees and suppliers. Their risky decisions include buying companies and extracting dividends by loading them with high levels of debt and selling assets. These actions often lead to financial distress and a disproportionate focus on cost-cutting, outsourcing, and wage and benefit losses for workers, especially if they are unionized. Because the law views private equity firms as investors rather than employers, private equity owners are not held accountable for their actions in ways that public corporations are. And their actions are not transparent because private equity owned companies are not regulated by the Securities and Exchange Commission. Thus, any debts or costs of bankruptcy incurred fall on businesses owned by private equity and their workers, not the private

equity firms that govern them. For employees this often means loss of jobs, health and pension benefits, and retirement income. Appelbaum and Batt conclude with a set of policy recommendations intended to curb the negative effects of private equity while preserving its constructive role in the economy. These include policies to improve transparency and accountability, as well as changes that would reduce the excessive use of financial engineering strategies by firms. A groundbreaking analysis of a hotly contested business model, *Private Equity at Work* provides an unprecedented analysis of the little-understood inner workings of private equity and of the effects of leveraged buyouts on American companies and workers. This important new work will be a valuable resource for scholars, policymakers, and the informed public alike.

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Customer Reviews

Deregulation of the financial markets and investor thirst for higher profits have given an enormous boost to private equity financiers. They buy companies, issue huge debt, and reconfigure or dismantle them for profitable returns, sometimes at the expense of workers, suppliers, customers, and creditors. Yet because they are not publicly owned, private equity firms have little transparency or accountability. Economic scholars Appelbaum and Batt shine some light on the shadowy world of private equity and its high risk-reward profile. They clearly explain how private equity investments differ from publicly traded companies and explore their impact on the broader U.S. economy, particularly because so many pension funds are investors in private equity deals. They explore the impact of private equity deals on the labor market as more and more acquired companies are

encouraged to reduce their workforces to give greater return to investors. Finally, Appelbaum and Batt recommend changes in public policy to reduce incentives that overburden companies with debt and to promote greater transparency in such deals. A dense but accessible look at a little-understood sector of the financial markets. --Vanessa Bush

EILEEN APPELBAUM is senior economist at the Center for Economic and Policy Research, Washington, D.C. and Visiting Professor in the Management Department, University of Leicester, UK. ROSEMARY BATT is the Alice Hanson Cook Professor of Women and Work at the Industrial and Labor Relations School, Cornell University.

Appelbaum and Batt begin with a success story "a private equity (PE) group buys a specialist sausage maker, expands the workforce from 140 to 350 in three years and resells the company to a major foods group. However, once you read beyond the first paragraph the message is less positive and the majority of the book will be a depressing read if you are an employee of a PE-owned company (i.e. a portfolio company). A private equity firm is controlled by the general partners who typically contribute just 1 or 2 percent of the working capital while the remaining equity is provided by limited partners such as pension funds who commit their investments for an extended period which can be up to 10 years. PE funds improve their returns by the aggressive use of leverage whereby they may borrow as much as 94% (in the sad case of KB Toys) of a target company's purchase price. With a highly leveraged purchase, a small increase in the value of the company can produce a large return to the owners and the general partners are also in the fortunate position of using other people's money to buy a company which may then hire them as highly paid consultants. "The general partner receives three streams of income: management fees from the limited partners, profits from investments, and fees from the portfolio companies." Loans are easier to obtain when they can be secured against tangible assets such as property so retailers and restaurant groups have been common acquisition targets and A&B present several case studies where such deals have resulted in bankruptcies and mass layoffs. "the Wall Street Journal's analysis of Bain Capital's performance found that of the seventy-seven businesses that Bain invested in from 1984 to early 1999, 22 percent either filed for bankruptcy reorganization or were liquidated by the end of the eighth year." "When a portfolio company defaults on its debt repayment, this does not directly impact the PE owners because of the protections inherent in the status of a limited company." "U.S. corporate law recognizes corporations as legal entities separate from their shareholders, officers, and directors.

Corporate obligations are the liability of the corporation, not of the shareholders who own the corporation." This separation becomes strained when the owner is a PE group which appoints all the company directors and the authors offer a few case studies where the owners have been held liable for debt and at least one other instance where they were asked to underwrite it and refused to do so. A&B provide many case studies to support their arguments and there are extensive notes and references which comprise 22% of the Kindle edition. However, the book is somewhat repetitious for the general reader and the same issues of excessive leverage, moral hazard and perverse tax incentives seem to be raised again and again. The academic style with numerous citations in the text detracts from the clarity of the explanation and footnotes would have been preferable. The exclusive focus on US examples is also somewhat limiting especially since Applebaum is a UK-based economist. Given the large number of case studies, it would have been helpful to present them in a more uniform format and to list them in a separate index. Chapter 6 assesses the performance of PE funds with a particular focus on the internal rate of return. However, the authors neglect to explain how this is calculated perhaps subscribing to Stephen Hawking's adage that including the formula would halve their sales and their largely verbal attempts to explain its limitations are vague and difficult to follow. More worked examples and graphics would have been helpful. At the time of writing, the Kindle edition is on sale for about \$4 and, at that price, it is very good value. If you are just skimming through it, the case studies in chapter 3 are probably the most interesting particularly that of the medical software supplier, Awarix. Case studies with largely negative outcomes (for stakeholders other than the general partners that is) are so numerous it is not worth singling any out just open the book at random. The Kindle edition is reasonably well presented. Figures can be expanded to full page and there is a comprehensive index with hyperlinks. However, the publishers should be aware that it is not possible to flip through a long index on a Kindle so it really needs to have a thumb index with a hyperlink to the start of each letter.

I am twenty per cent through the Kindle version and am very impressed with the clarity of the ideas presented. It is apparent to me that PE is a means of using debt and its favorable tax treatment to leverage economic equity out of companies taken private while externalizing costs onto company employees and taxpayers. There is no benefit to society and only costs, all to benefit the PE partners. The PE paradigm is yet another example of unregulated, predatory capitalism.

Excellent discussion of how private equity works; how it affects workers; how workers and their

unions respond and of the role of pension funds as investors in private equity.

This was a very good read because it is insightful , well written, and balanced. I recommend this book to anybody in business (including employees), not just the financial industry.

A good way to learn about private equity with real world examples. Even if you do not know anything about private equity this book is simple enough to learn about it.

Very informative.

Eileen Appelbaum and Rosemary Batt show with much conviction how much influence private equity (PE) firms have acquired through their ownership and control of Main Street companies across the US economy. Ms. Appelbaum and Ms. Batt also cover PE firms operating abroad whenever appropriate for the understanding of their examination of PE. To their credit, Ms. Appelbaum and Ms. Batt don't characterize all PE firms as uniformly harmful to the acquired companies and their stakeholders. Some PE firms - especially those that buy and sell small or mid-market companies with enterprise values lower than \$300 million - may undertake profit-seeking activities by creating value and increasing wealth not just for themselves, but also for the acquired companies and their stakeholders. Unfortunately, all too often PE firms undertake rent-seeking activities that maximize their own returns while putting operating companies and their stakeholders at risk. Both authors examine financial engineering activities such as high leverage, the sale of assets, tax arbitrage, dividend recapitalizations, and the use of bankruptcy proceedings under rent-seeking activities. Ms. Appelbaum and Ms. Batt call for thirteen policies to rein in the PE excesses that they documented in the book under review:

- 1) Curb private equity compensation to reduce moral hazard and risky behavior. The current legislation on this subject does not have real teeth to reduce the incentives for excessive risk-taking for financial institutions, including PE firms.
- 2) End preferential tax treatment of carried interest. Both authors argue that the general partners of PE firms are similar to real estate developers and should be taxed accordingly.
- 3) Reduce incentives to load portfolio companies with excessive debt. The tax advantages of debt amount to a subsidy from taxpayers, contributing substantially to the PE funds' returns.
- 4) Limit debt. Ms. Appelbaum and Ms. Batt contend that legally binding regulations would be a more effective enforcement mechanism than existing guidelines on this subject.
- 5) Discourage further PE's contribution to the growth of the shadow banking system. Both authors note that the current reporting is a necessary but insufficient

step in the right direction. They call for a legal framework that establishes limits on the use of leverage, subject to review by regulators.⁶⁾ Reduce incentives for asset stripping. Removing the limited liability protections of PE shareholders in cases where the assets of a newly acquired portfolio company are sold off would reduce the incentives to engage in such behavior when it is contrary to the company's interest.⁷⁾ Prohibit dividend payments to PE investors in the first two years. That moratorium would curb the most reckless use of dividend payments to PE shareholders.⁸⁾ Increase transparency. The Institutional Limited Partners Association (ILPA) principles should propose that PE funds report quarterly, using final public market equivalent (PME) values as a more accurate guide to fund performance compared to the internal rate of return (IRR).⁹⁾ Update the Worker Adjustment and Retraining Notification (WARN) Act to recognize the role of PE owners as employers. Recognizing the liability of PE owners who exercise de facto control over decisions regarding mass layoffs and facility closings would assure workers and communities of the protections that the US Congress intended when it required employers to provide sixty days' advance notice of shutdowns.¹⁰⁾ Hold PE equity owners accountable for portfolio companies' pension liabilities. The authors argue that the Employee Retirement Income Security Act (ERISA) and certain provisions of the bankruptcy code do not offer enough protection to the deferred income that workers earn during their working years and receive when they retire.¹¹⁾ Update ERISA. Against this backdrop, the US Congress should act to remove any doubt about the obligations of PE funds for employee pensions.¹²⁾ Update the bankruptcy code. Ms. Appelbaum and Ms. Batt contend that the US Congress should restore a fair and equitable balance among the competing interests of a bankrupt company's secured and unsecured creditors.¹³⁾ Require severance pay for employees linked to years of service. Analogous to the "golden parachutes" that companies typically provide to executives, such severance packages would give lower-level employees comparable protection against the negative effects of job dislocation. To their credit, both authors recognize that it will be challenging to achieve these policy reforms for four reasons:¹⁾ The financial services industry spends much on campaign contributions and lobbying to defend its interests.²⁾ "Regulatory arbitrage" can lead to sub-optimal regulations.³⁾ The "revolving door" between employment in the financial services industry and public-sector employment in regulatory agencies can be shut to politicians and regulators who push "too hard" on this subject.⁴⁾ This "revolving door" can lead to "cognitive capture" of regulators who tend to embrace the perspective of their (former) industry rather than that of the public. Ms. Appelbaum and Ms. Batt contend that PE firms that make their money as advertised by the Private Equity Growth Capital Council (PEGCC) and other industry advocates, by adding value to the portfolio companies they acquire, will see little

difference as a result of the policies mentioned above. In summary, the book under review, especially the policies advocated in chapter 9, is guaranteed to generate controversy.

I have first-hand experience as a manager in a portfolio company, and as friend and colleague of many others in the private equity ecosystem, both in PE firms and in operating companies. This book completely captures the business and economic realities of PE, and it does so with an informative and detailed historical perspective that frames recent economic (and social) developments well. First and foremost, it's a great book about PE, but it's also a book about the late 20th century rise of finance and new forms of financial engineering as a social force displacing stakeholders by shareholders. Everything in this book rang true to me.

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