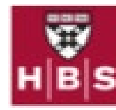

The Engagement of Private Equity with Employees of Portfolio Companies

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Concerns about inequality in the American economy have grown ever more substantial over the years. Often, discussions of this issue are linked to those about the "financialization" of the economy—worries that financial transactions can enrich the few while detrimentally affecting many others. In this session held on September 14, 2022, we explored a novel academic study trying to understand the impact of private equity on workers across a wide variety of dimensions. We discussed an effort by business leaders and investors to provide all employees with the opportunity to participate in the value they help create. Lastly, we examined how a pension seeks to ensure that they simultaneously return enough to provide their participants with a good retirement and contribute to a world with equal opportunity for all and good working conditions. The panelists included: Sabrina Howell, Associate Professor of Finance, NYU Stern School of Business; Andrew Stern, International President and President Emeritus, Service Employee International Union (SEIU), and Senior Fellow, Economic Security Project; Greg Jania, Global Co-head of Private Equity, APG Asset Management; and Peter Stavros, Co-Head of US Private Equity, KKR and Founder and Chairman, Ownership Works. Josh Lerner from the Harvard Business School and Private Capital Research Institute was the moderator.

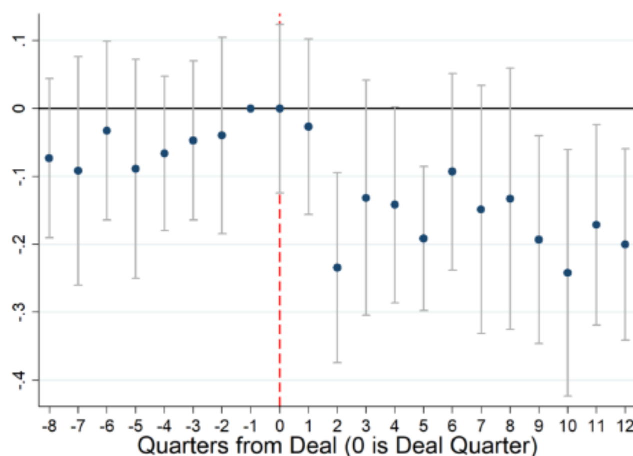
In 2021, according to Federal Reserve data, the wealthiest 10% of Americans held $36 trillion in stocks and mutual funds, an increase of more than 21 times since 1989. In contrast, the bottom 50% held a mere $260 billion, an increase of only 12 times over the same period.[1] This wealth disparity has drawn much attention to the relationship between private equity (PE) investors and the employees of the companies they own. Many perceive private equity investors as enriching themselves and senior management of their portfolio companies at the expense of lower-level employees ("making millionaires" rather than creating jobs).

At least some data seem to confirm this. At a high level, a recent study[2] finds that after controlling for mergers and acquisitions, job losses are higher for PE-backed firms. In addition, the study also finds that even though there is about an annual one percentage point gain in productivity in buyouts (this is substantial as most buyouts are in mature industries), wages seem to fall after

[1] Miriam Gottfried, "Private Equity Giants Back New Nonprofit Promoting Employee Ownership," *Wall Street Journal,* April 5, 2022, https://www.wsj.com/articles/private-equity-giants-back-new-nonprofit-promoting-employee-ownership-11649151000.
[2] Steven J. Davis, John Haltiwanger, Kyle Handley, Ben Lipsius, Josh Lerner, and Javier Miranda, "The (Heterogenous) Economic Effects of Private Equity Buyouts," Working Paper, 2019, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3465723.

buyouts. Lastly, in Figure 1 below, a study by Sabrina Howell and her colleagues[3] shows that employee satisfaction with compensation declines in high-leveraged buyout transactions. Given these data, it is natural to wonder whether private equity is good or bad for society.

Figure 1



Shifting Momentum Towards Closing the Gap

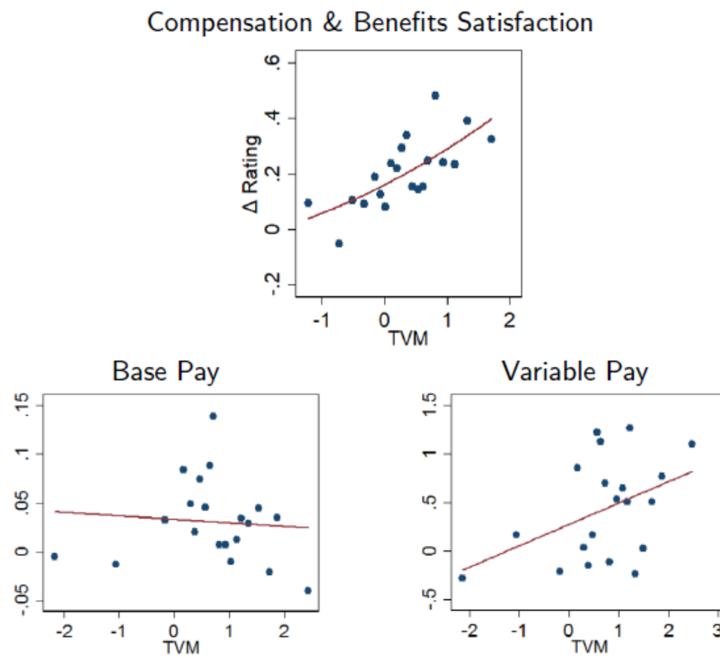
To further understand the nature of the relationship between private equity and employees, Howell and her co-authors study how the performance of private equity investments affects employee perceptions of job quality, which includes compensation and non-pecuniary amenities such as job satisfaction and work-life balance.[4] In Figure 2 below, the authors show that there are benefits to job satisfaction when an LBO is successful, which is consistent with rent sharing. The top graph shows a positive correlation between satisfaction with compensation that employees experience and the total value to paid-in multiple (TVM) of the transaction. In the bottom two graphs, the authors show that this satisfaction is primarily driven by a marked increase in variable pay rather than base pay. They also find that a 1% higher deal IRR maps to approximately a 7% increase in incentive pay. Thus, providing equity ownership opportunities to employees of LBOs could help align interests further and increase overall job satisfaction. However, these benefits are most likely for the top 35% of employees, who are already better off.

[3] Will Gornall, Oleg Gredil, Sabrina Howell, Xing Liu, and Jason Sockin, "Do Employees Cheer for Private Equity? The Heterogenous Effects of Buyouts on Job Quality," Working Paper, February 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3912230. Satisfaction was measured using Glassdoor job reviews (over 3 million reviews from 271K companies during 2008-19).

[4] Gornall, *op. cit*.

Figure 2

Changes in Job Quality & Returns to Investors (Total Value Multiple)



Worker dissatisfaction is an epidemic that impacts companies irrespective of whether they are PE-owned. According to the Gallup polls in 2022,[5] only 32% of all workers are engaged on the job and 17% are actively disengaged, down two percent and up one percent from the previous year, respectively. This lack of engagement is hugely problematic as employees significantly impact the firms they work for: e.g., interfacing with customers, determining productivity, and facilitating on-time delivery. The high cost of recruitment, training, and loss of company-specific knowledge when an employee quits is also problematic. Thus, investors are seeking new ways of value creation by focusing on employees' welfare.

Equity Ownership Programs

A number of GPs are experimenting with providing ownership opportunities to employees to create higher retention and job satisfaction. Ownership programs are promising because they presumably help align employee interests with the interests of the firm. However, despite their potential, very few equity ownership programs have been implemented thus far.

[5] Jim Harter, "U.S. Employee Engagement Slump Continues," Gallup Workplace, April 25, 2022. https://www.gallup.com/workplace/391922/employee-engagement-slump-continues.aspx.

Part of the challenge with these programs is that junior employees find equity sharing difficult to understand, as such schemes have typically not been offered beneath senior management levels. Also, trust is a large part of the problem: many line workers simply do not trust management. Starting an equity ownership program takes years of education, as well as sharing of future plans for the business.

As a result, the success stories to-date have typically been multi-year projects. In one example of success, the employee quit rate dropped from 20% to 2.5%, and employee engagement using Gallup polls increased from the 19th to the 90th percentile. However, it took almost a decade to accomplish these results.

Standards for Labor

Whether or not workers are owners, another question is whether government regulation can play a role in creating more stability for workers. Unlike the U.S., many countries impose strict standards for labor. For example, many European countries have strict rules around dismissing employees, where severance pay is guaranteed. In Germany, employees have a voice on their companies' boards. In the U.S., there are few standards around pay equity, employee rights in case of job loss, employee input into corporate decision-making, healthcare programs, or retirement plans.

However, policy solutions have their own challenges. In today's highly polarized environment, the panelists agreed, it would be a long wait for an effective policy response to emerge. Moreover, some panelists raised concerns about the unintended consequences of the wholesale adoption of European labor standards to the U.S. In particular, a number of academic patterns have suggested that these rules in some cases can introduce rigidities that limit entrepreneurial dynamism and new hiring.[6]

Limited Partners' Influence

Although the PE industry as a whole is unlikely to self-impose labor standards, the limited partner community has a considerable influence over where money goes. In theory, it could play a role in influencing the relative weight that PE investors put on employment considerations.

Indeed, as private equity has become larger and its economic role more controversial, some LPs have added the welfare of workers to their list of priorities. More LPs are pushing for an environmental-social-governance (ESG) agenda, evolving away from return-seeking alone.

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[6] For instance, see Luis Garicano, Claire LeLarge, and John Van Reenen, "Firm Size Distortions and the Productivity Distribution: Evidence from France," *American Economic Review*, 106 (2016), 3439-79, and Alberto Alesina, Michele Battisti, and Joseph Zeira, "Technology and Labor Regulations: Theory and Evidence," *Journal of Economic Growth*, 23 (2018), 41-78.

Several LPs now require their GPs to track job growth, job satisfaction, higher pay, better-quality jobs, and diversity. But these efforts have inherent tensions, as promoting ESG may not always align with the maximization of financial returns. In the end, LPs, especially underfunded pensions, must generate returns, so there may need to be some compromise. Moreover, ESG efforts can themselves become politicized, as the recent steps by Governor DeSantis to eliminate ESG considerations from the state pension investments illustrate.[7]

Moreover, it is challenging to ensure that these employment issues have the same priority as other ESG considerations. Pension funds, which have historically championed worker issues, are now investing less as a percentage in PE than in earlier decades. Another challenge is the lack of transparent data, which makes it difficult to assess how responsible a given GP is on worker issues.[8]

Summary

In an ideal world, employee engagement in PE transactions can be a "win-win," leading to greater worker satisfaction and higher returns. Equity ownership programs can have an impact on retention but are hard to implement and take a long time to yield fruit. Meanwhile, there is a substantial need for systematic data that will allow LPs to assess different PE investors on these measures. While these tasks seem daunting, there is a tremendous opportunity for GPs to differentiate themselves to create both firm value and happier employees.

[7] "Governor Ron DeSantis Eliminates ESG Considerations from State Pension Investments," State of Florida, August 23, 2022, https://www.flgov.com/2022/08/23/governor-ron-desantis-eliminates-esg-considerations-from-state-pension-investments/.

[8] Given these challenges, a response by a number of LPs has been tilted away from distressed buyouts and more toward growth and venture capital, which they hope may be less problematic in this regard. Such a move may also have unintended consequences.