The Consequences of Private Equity on Employment and Management

A Roundtable Sponsored by the Private Capital Research Institute, the Institutional Limited Partners Association, and the Private Capital Project at Harvard Business School (underwritten by the Division of Research at Harvard Business School)

On September 6, 2017, a group of limited partners, academics, and general partners met to share perspectives on the broad social consequences of private equity investments. The discussion highlighted the fact that environmental, social, and governance (ESG) factors have become an important part of the investment evaluation criteria of many asset owners, particularly in Europe. However, there was no consensus in terms of an optimal approach in measuring or weighing such factors in the investment review process.

Academic studies suggest private equity investments contribute to improved productivity, product safety, labor safety, and increased variety and availability of products to consumers. However, the evidence regarding job creation and wages is not as positive.

Perhaps as a result of these mixed results, labor is still wary of private equity, viewing it as short-term in nature, with a focus towards exiting businesses for a quick profit. Also, with private equity investments, labor often feels disconnected with whom they perceive to be the true decision makers, namely the private equity sponsors rather than management. With increased transparency and leadership from the investment community, there is an opportunity to make improvements that will strengthen the relationship between private equity firms, companies, and workers in the firms in which they invest.

Limited Partnership Perspective

Suzanne Streeter, Senior Investment Principal at Partners Capital, led a panel discussion on the consequences of private equity on employment and management with a group of limited partners. Discussants included Greg Jania, Head of Fund Investing at APG Asset Management, Thomas Ruggels, Senior Investment Officer at Washington State Investment Board, and Russ Steenberg, a Managing Director at BlackRock Private Equity.

Suzanne Streeter began by inviting the panelists to share their perspectives on how their respective firms evaluate and incorporate social impact into investment decisions. Over the past few decades, the panelists explained that ESG factors have become a more important component of the investment process, with the emphasis varying across regions and sectors. Historically, Europe was the driving force behind the focus on ESG factors, which has now become a standard part of due diligence for many LPs.

The panelists discussed how social impact and employment factors influenced their selection of GP partnerships. To evaluate and monitor the condition of social impact, many LPs have adopted an internal scorecard that looks at factors such as climate change, diversity, employment, supply chain integrity, and labor practices, among others. They require their GPs to meet a minimum standard, and seek an improvement of their scores overtime. Often third-party consulting firms are engaged to determine the scores and rank private equity managers. In addition, some GPs have developed internal ESG dashboards tracking such factors as employment levels and wage growth, carbon footprint, and safety.

While there clearly needs to be an industry standard, ESG factors are still only a part of the investment decision and not typically a primary driving factor. That said, there are a few LPs for which ESG can be a gating item. There is a delicate balance for most LPs to manage both social impact and financial return expectations. Even if a GP scores highly on social impact metrics, it does not guarantee a fund commitment. Also, in economic downturns, it can be harder for some GPs to meet the minimum ESG requirements for some of their companies. Some smaller funds may have strong returns, but may find it harder to meet the requirements, due to the extensive data collection burden to comprehensively document ESG performance. Lastly, while social issues, such as diversity, are important to GPs, LPs, and portfolio companies' boards, there still needs to be autonomy for managers to make decisions to run their businesses to maximize profits.

Ultimately, LPs have a fiduciary responsibility. Investing in ESG funds should not come at the expense of performance. While some LPs find that there is correlation between ESG factors and financial returns, there is still not enough data for a definitive conclusion.

Academic Perspective

Josh Lerner from Harvard Business School led a panel discussion on the consequences of private equity on employment and management with a group of academics. Discussants included Shai Bernstein from Stanford University, Jonathan Cohn from University of Texas, and Albert Sheen from University of Oregon.

Private equity-backed firms by nature are private and not required to disclose their financial information. This lack of comprehensive and readily available data poses challenges to academic researchers who have to rely on non-standard data to analyze the impact of private equity. Moreover, determining whether changes are a cause or consequence of private equity financing can be challenging. In this panel discussion, a group of academics, led by Josh Lerner, discussed their research that seeks to investigate the consequences of PE on management, employment, and consumers.

Shai Bernstein described his research[1] with co-author Albert Sheen, which uses health inspection data from the U.S. Food and Drug Administration to explore whether PE firms disrupt or improve the operations of their portfolio companies. The research examines the operational changes in restaurant franchises in Florida from 2002 and 2012 that were subject to leveraged buyouts, using the FDA's health inspection reviews. The inspection scores of restaurants' kitchen operations allow the researchers to study the changes in store-level operational practices before and after the buyout, relative to franchises that did not undergo such a change in ownership. They find that the operational practices improved after a PE buyout. Restaurants became cleaner, safer, and better maintained, despite a decline in the number of employees. Such changes in operational practices benefit the restaurants and consumers. These results illustrate that PE firms are active investors that improve firm operations.

Jonathan Cohn, along with his colleagues Nicole Nestoriak and Malcolm Wardlaw, address the impact of PE on workplace safety of PE-backed companies. The researchers use the Bureau of Labor Statistics' establishment level data on workplace injuries to study how injury rates changed after a buyout.[2] Using a sample of non-PE backed firms of similar size and of the same industry, the researchers create a benchmark for changes in injury rates. They find a downward trend in the injury rates for all firms, but that the rates fell more steeply in private equity-backed firms, relative to a set of matched firms. The effects are far stronger in firms that were publicly traded prior to the buyout. Talking to the executives, they identify anecdotal evidence from management in publicly-traded PE-backed firms that suggests more long-term investments in employee training and streamlining production processes, practices which may be important explanations for the results.

The discussion then moved from PE's impact on portfolio firm's operations to the changes that consumers face after buyouts. Albert Sheen and his co-authors use detailed price and sales data for consumer products to analyze the product variety and prices that consumers realize after buyouts of consumer firms.[3] Comparing 64,000 consumer products owned by PE firms to 1.7 million products manufactured by non-PE backed firms, the researchers find that the target firms raise prices only marginally on existing products relative to similar products of non-target firms. However, they also discover that PE-backed firms are able to significantly increase sales due to more product introductions and greater availability, benefiting consumers with more choices for the same product category.

Lastly, Josh Lerner provided highlights from his co-authored research[4] that looks at 5,000 buyouts between 1980 and 2003 to investigate the impact of buyouts on employment and productivity. The researchers find a heterogeneous impact of PE on employment: there were large job losses in public-to-private buyouts, as well as some losses in divisional buyouts. But private buyouts, focusing on leveraged buyout, actually experienced an increase in net employment. Most of the buyouts in the 1980s and the 1990s were public to private. Lerner noted that this composition has changed, with the public-to-private buyouts representing a smaller share of the buyouts in the period 2004-2011. In forthcoming research, he will further explore this phenomenon. In terms of productivity, the researchers find the gap between productivity growth rates and growth in real wages seen in general U.S. economic data after the 1970s is even more pronounced in PE-backed firms. The annual productivity growth rate of target firms is on average 1% higher than the matched firms based on industry, size, age, and prior growth. Meanwhile, the wage growth of these firms is about 2% lower after the buyouts relative to the matched firms in the same period.

Overall this provides mixed results for consequences of PE on management, consumers, and employment. PE-backed firms show higher operational improvements, have lower workplace related injuries, and introduce more variety of products with higher sales. But the impact on jobs and wages are not as benign.

---

1) Bernstein, S., & Sheen, A. (2016), "The Operational Consequences of Private Equity Buyouts: Evidence from the Restaurant Industry," *The Review of Financial Studies*, 29(9), 2387-2418.
2) Cohn, Jonathan B., Nicole Nestoriak, and Malcolm Wardlaw, "Private equity buyouts and workplace safety," September 10, 2017, Working paper.
3) Fracassi, Cesare, Alessandro Previtero, and Albert Sheen, "Is Private Equity Good for Consumers?." April 26, 2017. Kelley School of Business Research Paper No. 17-12.
4) Davis, Steven J., John Haltiwanger, Kyle Handley, Ron Jarmin, Josh Lerner, and Javier Miranda. 2014. "Private Equity, Jobs, and Productivity." *American Economic Review*, 104(12): 3956-90.

GP Panel Perspective

Jeff Roberts, Director of Private Equity Research at NEPC, led a panel discussion on the consequences of private equity on employment and management with a group of leading GPs. Discussants included Steve Klinsky, Founder and CEO at New Mountain Capital, Karen Mills, Senior Fellow at the Harvard Business School and Chairperson of the Private Capital Research Institute, and Damon Silvers, Policy Director for AFL-CIO.

The panelists began by sharing their perspectives on the evolution of the private equity investment model. When private equity first became prominent in the 1980s, the typical model was chiefly driven by capital structure, with only a secondary emphasis on operational and strategic value added by the private equity general partner. Given the steadily rising stock markets in the 1980s and 1990s, GPs were generally able to get returns by simply investing with leverage, without the need to improve operations. This model changed in the up and down markets after the year 2000, and private equity general partners increasingly enhanced their firm's own operational and strategic skills in order to thrive. Today, private equity partners who are themselves skilled at business building, and who also have operating partners on staff, are an extremely important part of top quality private equity investment teams.

Perhaps based on the legacy private equity model of the 1980s, at least some representatives of the labor movement continue to have concern over the social impact of private equity. They worry that private equity investors are too short-term focused, as more leverage puts added pressure on their portfolio companies. They also worry that private equity firms have an eye towards exiting in 3-5 years, which may be a cause for concern in businesses with a long product cycle. Furthermore, they believe some PE groups still enter transactions purely for financial engineering purposes, rather than aiming to improve operations. They also believe that many employees may feel quite disconnected from the "true" owners of their firms, i.e., the private equity managers. These employees may feel they are never really interacting with the final decision maker in any negotiation over wages. Lastly, these organized labor representatives feel there is a constant tension due to the high income inequality that exists between the private equity investors and the workers at the firms in which they invest.

On the flipside, a negative perception of PE may not be supported by the facts since private equity often brings management skill and more patient capital to companies that need them. Some panelists indicated that in a public company, many of the perceived issues delineated above could be even worse, as managers deal with faceless shareholders who only focus on day-to-day stock prices. The case was made that private equity has the best features of a family-owned operation without the negatives of a family business: that is, private equity has close-to-the-ground, "hands- on" owners like a family business, but the owners have been chosen for their merit and skill, rather than through nepotism.

Overall, the panelists agreed that there is a tremendous need to improve information and understanding between various stakeholders. Some private equity GPs have already begun to publish their own performance statistics which prove significant job growth, with high wages, high R&D, and other investments in their portfolio companies. More GPs should self-report, and there is an opportunity for LPs to take a leadership role in creating standards for measurement of social impact, thus improving transparency into the investors' activities. Such steps would help eliminate generalities and would prevent the unfair lumping all 4,000 private equity firms into the same bucket.