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Work, employment and society
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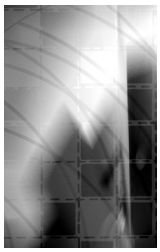
BSA Publications Ltd®
Volume 23(4): 1–12
[DOI: 10.1177/0950017009344920]
SAGE Publications
Los Angeles, London, New Delhi, Singapore and
Washington DC



Owners and managers: disconnecting managerial capitalism? Understanding the private-equity business model

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ABSTRACT
The 'disconnected capitalism' thesis constructs an argument that structural tendencies within capital markets disrupt established patterns of relations between employers and labour. This article develops this argument by conceptualizing how the 'private-equity business model' (PEBM) further diffuses these connections and trends. This diffusion is so extensive that the interests of owners are now paramount in all types of business system to the relative exclusion of other stakeholders. The article defines and explains the term 'PEBM' and identifies the theoretical importance of management in managerial capitalism. The article then goes on to outline how the PEBM disconnects the evaluation of institutional capability and managerial discretion at firm level from the economics of information and direct ownership interests at business system level.

KEY WORDS
disconnected capitalism / financialization / employment relations / private-equity business model

Introduction

'Disconnected capitalism' is a thesis developed by Thompson in this journal (2003), to argue that structural tendencies within capital markets disrupt established patterns of relations between employers and labour in the American and British business system. Financial de-regulation together with a globalization of markets has combined with the apparent dominance of a

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business model centred on delivering shareholder value in capital markets. It is the connections between these trends – the short-term imperative to generate revenue, new models of competitiveness that emphasize investor returns and a disdain for the interests of the customer, the employee and the exchequer – that have the effect of disconnecting more established circuits of capital which are embedded in national business systems. At this theoretical level Thompson (2003: 363–7) concluded that much leading edge theory and associated best practice, in particular literature sets (for example, strategic HRM and high performance work systems) are likely to be rendered unsustainable as employers become unable to maintain their side of the bargain.

This article develops the argument by theorizing how the 'private-equity business model' (PEBM) further diffuses the connections within this trend to assert that investor-owner interests are of growing prominence to the relative exclusion of other stakeholders. Thus, the article seeks to open out underdeveloped dimensions of the disconnected capitalism thesis by focusing on particular dynamics within the circuits of capital in an increasingly financialized economy and their potential impacts on employment relations within national business systems. The first half of the article details a theoretical outline of the PEBM and its impact on the relative theoretical importance of managers and owners. The second half of the article outlines the actual and potential consequences of the PEBM for employment relations at system level and at firm level by identifying three disconnects, which to paraphrase Thompson (2003: 366) – 'make it more difficult for employers to keep their side of the bargain', *even if they want to*.

The private-equity business model

Private equity is a pool of capital raised and managed for the specific purpose of investing directly in companies. A private-equity fund is actively managed by a plc fund management company or a limited partnership which may control numerous funds. Limited partnerships are the favoured vehicle for the PEBM for two reasons. Firstly, they have no legal personality yet individual partners operate collectively and secondly, fund managers (managing partners) and investors (limited partners) are taxed as individuals, therefore the partnership itself has no tax liability. The sector is broad in scope and includes venture capital funds which are a form of private-equity capital typically provided by professional institutionally backed outside investors who support the growth of new businesses. In addition to venture capital and mid-market private-equity funds, larger, multinational private-equity funds, acquire plc firms or divisions of plc firms by buying a controlling percentage of the shares which are listed on a public stock market. Once a fund has control of all the shares in a portfolio company the fund becomes the single shareholder and the firm is no longer a publicly traded plc company. This is what is referred to as the private-equity business model. So venture capital, mid-market buyout specialists and private

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equity are different fractions of capital, but what they do have in common is the manner in which funds have been raised – on private rather than public markets. The logic behind private equity and the broader umbrella model of shareholder capitalism is a contractual approach to business which sees a firm as a bundle of assets that can be managed on a contractual and transactional basis. The ultimate purpose is to generate cash flow and profits over short-term time horizons by financial and organizational manipulation. So while private-equity funds (as a fraction of capital), may be long-term investors, portfolio firms are viewed largely as short-term investments from which significant value can be extracted.

Theoretically, the diffusion of private equity as a driver of investor and shareholder value lies within corporate finance as an academic discipline and the associated theory of efficient capital markets (Jensen, 2007; Jensen and Murphy, 2009). The theory contains an efficient-contracting orientation to the firm, that is (capital) markets allocate resources to investments that secure the highest returns. Jensen and Murphy (2009) argue that in plc firms the performance of chief executive officers is often unrelated to their remuneration because CEOs are an indirect form of governance who represent owners poorly, often failing to influence employment contracts and management incentives or the monitoring mechanisms in respect of both of these. In contrast to this Jensen and Murphy assert the owner-investor advantages of private equity. For example, in private equity governed firms owner-managers have direct oversight over managers, their compensation and its link to performance.

Private equity and investor value

Acquisition by private equity, whether a buy-in to an existing private business or if a plc business is taken private, aims to unlock value for investors and the fund managers themselves. The PEMB is principally financed through debt, which is leveraged against company assets such as freehold property and pension schemes. The debt model secures up to 90 percent of a buyout by borrowing from institutional investors (limited partners) who support a particular private-equity fund. In contrast, fund managers (managing partners) put in only a small percentage themselves. To support a portfolio company and secure its debt, private-equity funds often disintegrate a business into an operating firm and a property company with the operating company leasing back the property on a contractual basis with the funds raised from property sales used to pay back debt funding. In addition to this, private-equity owners sometimes raise additional debt to finance dividend payments. A dividend recapitalization occurs where a portfolio company borrows money to make a cash payment to the private-equity fund which owns it. These payments are itemized on the balance sheet of the portfolio company as debt, that is, additional debt which pays a dividend to owners and fund managers. This is unusual to say the least as dividends are normally paid out of profits.

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How does the model create value?

The PEBM creates value for investors in four ways. One, a portfolio company – a bundle of assets – can be disintegrated, separated, sold and 'spun off'. Two, the weight of debt leverage directs management to focus only on short-term profits by unlocking valuable assets through sophisticated financial engineering to generate a 'free cash flow'. This drives management re-structuring and unbundling prior to an 'exit strategy' that aims to realize an investment after perhaps only five years. Three, private-equity funds often resent being referred to as an employer, preferring to describe themselves as 'active owners' or an 'asset class'. In the UK current legislation on the transfer of undertakings protection of employment (TUPE) regulations and the EU acquired rights directive uphold this position, as private-equity buyouts are not classed as a change of ownership that affects industrial relations. Active owners cannot unilaterally change terms and conditions of employment without employee consent. However, it is the choice of governance mechanisms favoured by the PEBM, offering, for example, union free communication and consultation that exhibits an orientation towards the management of employees that is substantively different to more traditional employers. This preference, and the absence of TUPE protection with respect to employee consultation on a collective basis, sustains a speed of action that gives private-equity owners first mover advantage. Therein employee consent to changes in the contract of employment is implied by dint of the fact that employees continue to work in and remain employed at a portfolio firm. Four, private equity enjoys significant tax breaks that are unavailable to plc firms which reinforce the value creating potential of private-equity vehicles for investors behind the funds and the fund managers themselves. Therefore, corporation tax from plc firms and income tax from employees in effect subsidize private sector profits.

The current crisis, financialization and private equity

The PEBM needs to be located within a broader context of financialization. This describes the dominance of the financial sector and how volatility therein has the potential to disconnect and disrupt the business system. Under the influence of neo-liberal ideology, financial de-regulation, particularly in the USA and UK, stimulated innovations in banking and lending models that transformed the acquisition of firms and the operation of financial markets, but is now in crisis. For example, private equity provides a model for governing portfolio firms and manages loan models for acquisition of such firms from 'shadow banking', which has emerged since the early 2000s. Based on low interest rates, high leverage and rising asset values a securitized loan model enabled banks to parcel up loans secured against property and sell them to raise 'new capital'. However, financial markets went into reverse in 2007 and the distributional disconnects of the PEBM became starkly evident as the value of many portfolio firms became lower than the loans that supported them, pushing some firms into liquidation and others into severe downsizing mode. Severe as this current

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crisis is, it should not lead to neglect of the longer term disconnects raised in the original Thompson article and extended here.

Manager and owner objectives: disconnects in historical perspective

Before we return to the current period, this section groups together and briefly outlines historically significant studies on the nature of firm governance and the connections between stakeholders. First, those studies that outline the conditions that gave managers a quasi-independence from owners. Second, how this in turn enabled management to become a quasi-independent stakeholder. Third, how some studies consider the disconnection between owners and managers can be 'solved' via more profit oriented governance mechanisms such as shareholder capitalism and the PEBM.

Management as an institutionalized business class: Disconnecting owners

Berle and Means (1932) identified the importance of the separation between ownership by entrepreneurs and investors and control by management and the implications of this for industrial capitalism. Coase (1937) observed that the emergence of the telephone and telegraph reduced the cost of organizing within the firm, but tended to increase the size of the firm. Operating more historically, Chandler (1962, 1977, 1990) developed three empirically informed, institutionally sequential arguments. First, managerial organization develops in response to business strategy, in particular the development of vertical integration. Second, the emergence of capital-intensive, machine-based mass production in a second industrial revolution in the late 19th century further increased the scale, size and scope of the firm, standardizing production and the regulation of jobs. Third, these arguments come together in the managerial capitalism thesis, which suggests that administrative structures and managerial coordination replace the invisible hand of market forces as the core developmental and structural impetus behind modern business. Chandler's argument is similar in scope to the more polemic arguments developed by Galbraith (1952, 1967). Galbraith argued that in most Western business systems firms are oligopolistic and therefore compete for market share not profit maximization. Within this management had wrestled organizational power away from owners through institutional developments such as vertical integration in production and pluralism in workplace relations, and the associated bureaucratization of management functions within the firm (Tsuk, 2005).

The objectives of the firm: Disconnecting profit maximization

By the late 1950s theories of the firm began to observe behaviour that was obvious: shareholders and owners, who fund a business, played virtually no part in running a firm, but instead preferred to secure a reasonable or satisfactory

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level of dividend income, leaving managers to actually control discretionary decision making. Under conditions of oligopoly or monopoly capitalism these behavioural or institutional theories modified the objective of profit maximization by hypothesizing that management discretion is more likely to further the interests of senior managers subject to a dividend constraint. Thus, March and Simon (1958) and Cyert and March (1964) argued that management behaviour was rational but only to a point, that is rationality is bounded and in practice management often opt for satisfactory solutions – satisficing rather than maximizing. Baumol (1959) argued that firms measure success through sales revenue maximization where management seek to increase business size (now termed growing market share) rather than profit maximization, and increase output beyond the maximizing level in order to outperform the market (increase market share) subject to a dividend constraint. This argument was further independently refined by Marris (1964) and Williamson (1964). Marris argued that the long-term growth of the firm is the main aim of management and that this may move a firm beyond profit maximization in terms of prices and outputs. In contrast to this, Williamson developed a thesis of 'managerial discretion' suggesting that management could decide how to allocate earned profits, retaining some profit to grow the size of departments, innovate new products and distribute remaining profit to shareholders. However, over the past 30 years a new stream of theory has emerged which firmly places the interests of business owners, investors and shareholders at the forefront of analysis.

'New economic theory and ownership': Re-connecting owners and disconnecting the management class

Drawing on micro economics, new theorizations describe the firm as a nexus of private contractual relationships subject to regulation by capital markets. The broadly defined new economics contains several bodies of analysis which rationalize the emergence of owner interests such as shareholder capitalism and one of its central features – the PEBM. As early as 1962 corporate managers were theorized as 'shareholder agents' compelled to manage a firm in ways that maximize the profits of their principals, to the exclusion of all other interests in the firm and the community at large (Friedman, 1962: 132–7). By contrast, agency theory, like behavioural and managerial theory, conceptualizes the firm as an organization made up of groups who hold diverse and conflicting interests (Jensen, 2007; Jensen and Meckling, 1976). Owners, investors and shareholders (the principals) seek profit maximization whereas managers (their agents) are likely to have different priorities, for example, reputational success, job security, industry profile and other perks. Agency theory predicts that firms will operate in the interests of owners, and deliver investor and shareholder value, if owners and investors can impose their priorities on management to develop a contractual approach to management and investment returns. In effect this takes the form of a partnership agreement between fund managers and professional institutional investors. Instead of accepting the presence of residual loss, owners and investors

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such as private-equity fund managers can limit both managerial opportunism (formerly satisficing and management discretion) and the countervailing interests of non-shareholder stakeholders (formerly more inclusive distribution) through a combination of incentives and monitoring mechanisms.

The private-equity business model and employment relations?

What disconnection?

The theoretical argument developed herein suggests that business strategies and approaches to corporate governance are, within contemporary capitalism, dominated by investor and shareholder interests. In addition to this, accumulation strategies associated with these interest groups, such as the PEBM, disconnect evaluation of employment relations as a practitioner concern and a broadly defined academic discipline. This is the case because the PEBM is not readily evaluated theoretically or empirically beyond its alleged efficiency bearing characteristics, which are measured more or less exclusively in terms of investment returns. Indeed, at firm level the ways in which business strategy and corporate governance is informed and shaped by the PEBM, and how in turn this informs and shapes approaches to employment relations, is unclear. Other than references to the institutional configuration of the American and British business system and the short-termism that this encourages, the broadly defined community of employment relations scholars appear to have ceded critical evaluation of the distributional impact of the PEBM on the basis of first mover advantage to those who articulate its efficiency credentials.

Corporate governance and employment relations under private equity

Theoretically and empirically businesses governed or potentially governed by the PEBM are presented as exemplars of competitive success. This is the case because the theory of efficient capital markets and the logic of private-equity acquisition stimulate efficiency either in management action at the level of the firm or in the market for corporate control. The attraction of private-equity funds for investment practitioners and institutional investors is the comparatively high rates of return which (prior to the recent credit crunch) averaged between 15 percent and 20 percent compared to average returns of 6 percent for the FTSE all share index (BVCA, 2008). These returns lead academic supporters and practitioners to argue that businesses governed by private equity secure higher returns for investors and shareholders, deliver higher productivity and create more jobs than equivalent plc firms (Bacon et al., 2004; BVCA, 2008; Gilligan and Wright, 2008). In many cases the business model does secure the benefits identified in these claims and the studies that support them. As Thompson (2003: 359) points out, those who ply their trade by purveying ideas – academics, policy entrepreneurs and consultants – have a vested interest in proclaiming the new and representatives of each of the three purveyor

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groups argue that workers have nothing to fear from private-equity ownership. Gilligan and Wright's (2008: 39) survey studies of how private equity impacts on HRM conclude that the picture is mixed but not negative. Similarly, CIMBOR (2008) for the European Venture Capital Association (EVCA) argue that across Europe private equity has little impact on employee relations but on average increases employee earnings. The Walker Report (2007) on disclosure and transparency in private equity proposed a continuation of voluntary regulation and was therefore largely silent on employment relations. However, below the survey method that the majority of these studies employ, there is no theoretical evaluation of private equity or the PEBM at business system level, firm level or workplace level other than references to stock terms such as active ownership, rapid organizational change and powerful management incentives. Indeed, an EU sponsored study found that the financial success of private equity is the only focus of most studies. Therein returns to internal stakeholders (investors and owners), is paramount, with a focus on employees or change in workplace employment relations beyond the rubric of these studies (Gottschalg, 2007). This first mover advantage makes it much harder to argue that not everyone is a winner in these situations – so paraphrasing Thompson (2003); how might employers find it more difficult to keep the employment relations side of the bargain?

First, at system level, what remains academically unstated is that the diffusion of the PEBM and the growth of the private-equity sector is a competitive driver behind the move to shareholder value as a key measure of corporate performance. Theoretically this driver is the missing competitive and institutional innovation identified as the limiting factor in the diffusion of shareholder capitalism and its operational sustainability. O'Sullivan's (2000: 2) historically informed evaluation of contemporary developments in business strategy demonstrates that, in order to sustain investor and owner interests in shareholder capitalism, managerial practice must be exclusively re-aligned towards owner-investor interests. But more significantly, it is necessary to legitimize this for workers, employers and society. The PEBM creates and sustains investor value but requires a 'downsize and distribute' approach to business strategy, corporate governance and the management of employment relations. Agency theory provides the economic justification for this, citing the 'slack' and wasteful spending under managerial discretion. This rationale legitimizes the extraction of value from a wide group of stakeholders, re-distributing it across a narrower group of key private-equity fund managers and investors.

Across business systems the contentious efficiency claims of the PEBM are perceived by some actors and institutions as socially inappropriate and therefore less legitimate. As Thompson (2003: 368) suggested, comparatively not all developments are generalizable across different types of business systems but trends in product and capital markets do make the world smaller and diminish institutional distinctiveness. The global presence of private-equity funds is one such trend that is currently testing forms of capital, patterns of corporate governance and employment relations more patient than American and British variants. Empirically, it is clear that private equity and the PEBM operate across

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the EU (see Watt, 2008: 550–53) but, empirically, many American and German firms and the majority of those in other business systems remained wedded to national variants of managerial capitalism on the Chandlerian model. So, while some 'capital*isms*' might be more disconnected than others, the movement towards investor and shareholder capitalism at system level dictates that private equity and its associated business model become significant actors across different types of business systems.

However, diversification in ownership or governance regimes at firm level and movement towards a market-focused investor-driven model of employment relations will be mediated by the embeddedness of established practices. Stakeholder business systems such as Germany and Japan do encounter foreign and domestic diffusion of private-equity investment, but this engagement with the PEBM must evolve incrementally from a defined and systematically embedded starting point. Empirically, this engagement may result in hybrids that continue some emphasis on stakeholder approaches at firm level. However, at system level measures of convergence, such as the financialization of change, manifested primarily in the growing prominence of credit and private equity, co-exist with national divergence in the impact of financialization at firm level. Analytically this reinforces established arguments in the 'converging divergencies' thesis (Katz and Darbishire, 2000).

A second disconnect for employment relations centres on the efficiency-based discourse of private equity. Key (self-) attributes associated with private equity at firm level – active management, rapid organizational change and powerful management incentives – appear to be sufficiently attractive to both practitioners and academic supporters to induce a state of amnesia with respect to the potential impacts on workers at the receiving end of these attributes. Theoretically these attributes can deliver value for fund managers and investors, but the actual and potential employment relations outcomes of each attribute may have distributional as well as efficiency consequences for workers. In comparison to plc firms, those governed by the PEBM (around 8% of American and British private-sector employment) have higher leverage, a shorter-term focus and requirement to service debt before any exit, and are more likely to sell and downsize assets (including business units and pension schemes) by around 10 percent (WEF, 2008). So while some survey sources praise the efficiency credentials of private equity backed firms, the discipline of financialization at system level conflicts with a longer term organizational focus on HRM at firm level.

The potential of a third disconnect requires critically informed empirical evaluation. Firms governed by the PEBM re-connect investors and owners and disconnect managerial discretion within its institutionalized business class where managers built overstaffed empires, paid themselves too much for not very much, and avoided conflict with workers, customers, suppliers and taxation authorities. The hegemony of agency theory is unable to countenance the possibility that owner-investor interests may generate inefficiency. A reliance on share options and the promotion of share price growth may generate a bigger share of value-added remuneration, but what is empirically less clear is that this may not

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be the same as an increase in value added activities. Similarly, re-directing returns to managers, owners and investors and aligning the interests of employees with these groups may validate agency approaches, yet the revenues now accruing to these groups would have been reinvested or distributed to a wider group of stakeholders. It may be the case empirically, and it is the case theoretically, that corporate governance on the basis of the PEBM has a significant influence on the reciprocity of commitments between employer and employees which in turn will have an impact on the effectiveness of HRM regimes. Thus, in agency theory, re-connecting finance and corporate capital can disconnect corporate strategy and HR policy in the manner captured in Thompson's argument that employers find it more difficult (even if they aim to) to keep their side of the bargain as a result of developments in the financial circuit of capital.

Conclusions and theoretical reflections

This article does not question the attraction of the PEBM for investment practitioners. What it does seek to highlight is the disconnection between the financial performance of private equity backed firms and the performance of the business system as a series of integrated embedded institutions. This is the way in which I develop the term disconnected capitalism from the position laid out by Thompson (2003). My usage of the term highlights a disconnect between employer objectives at the level of the firm and the shift to the imperative of investor and shareholder value as a business system driver. This does not mean that HR commentators who highlight the central significance of resource-based approaches to the firm, or business partnership models for strategic HRM, are wrong or in denial. However, the issue of financial performance, now calibrated on the basis of investor and shareholder value at the level of the business system rather than strategic choice in HRM at firm level, is not integral to their analysis.

As with Thompson's thesis, this article is not merely a critique. It seeks to analyze a current development present in most business systems, not in the form of a model building exercise but in terms of the disconnecting effects that private equity and the PEBM have on established circuits of capital and institutionally defined management and labour interests in national business systems. For example, how much of the capital in the British business system has to be owned by private equity before the variations in patterns of ownership, corporate governance and employment relations weaken the idea of a British (based and owned) business system to the extent that the idea becomes less workable as a methodology for research? Currently, less than 10 percent of British business is disconnected from the institutional routine of the British business system. The argument presented here is incomplete – a critically based systematic empirical evaluation of corporate governance and employment relations under the PEBM is yet to be undertaken. Yet the further disconnects highlighted here may expose key organizing concepts

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deployed by academics – the country of origin effect in international business and comparative and international HRM. What nationality are these firms; who actually owns them and within which corporate governance regime are they registered and regulated?

Acknowledgments

I would like to thank Jason Heyes and Helen Rainbird for comments on an earlier version of this article and the WES referees for their useful comments and observations.

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Date submitted September 2008

Date accepted April 2009