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Davos 2008 report on private equity validates unions' concerns on jobs – but more work needed

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On 25 January the World Economic Forum (WEF) released a first report on private equity as part of an on-going project on "Globalization of Alternative Investments"[1]. The findings show a negative effect of private equity buy-out transactions on employment. On process, the WEF project is welcome in so far the organisers have included union representatives as well as the private equity industry. However there are methodological questions raised by the current report – both geographic and policy-related – that need to be addressed in the next phase of this initiative.

The WEF report consists of four impact studies on the "demography" of the private equity industry (duration and outcomes of private equity transactions), its impact on employment, on innovation capacities, and on corporate governance of the portfolio companies. A key finding of the report – one that was most widely reported in the media – concerns the quantitative employment impact of private equity. It shows that private equity transactions are typically preceded and followed by an abnormal depression in employment levels and that the latter only catch up with non-private equity levels after 4 to 5 years. Job destruction appears particularly severe in the services sector, where "the cumulative five-year impact is 9.7% lower employment" in private equity-owned companies than comparable non-private equity averages. The WEF study contradicts the enthusiastic private equity industry–backed "surveys" that are regularly posted on the web to show how private equity creates jobs.

Other key findings of the "demography" study include:

- 42% of the private equity funds' investments are exited within five years of the initial transaction, 8% within two years;
- Between 1970 and 2002, 7% of buyout transactions ended in bankruptcy or financial restructuring, leading to an estimated annual default rate of 1.2% per year, that is twice the rate for publicly traded firms;
- The share of "secondary buy-outs" and sales to LBO-backed firms in the total annual number of LBO exits has increased continuously in the past decade, reaching 36% of all exits in 2003-2005.

The WEF report ranks among the most comprehensive impact analyses of the private equity. There are however serious methodological questions – both geographic, policy-specific and theoretical ones – that need to be underlined and that restrict the generalization globally of the current findings of the project. These issues need to be addressed in the next phase of the Project.

A geographic bias:

[1] World Economic Forum publishes Volume 1 of Working Papers on "The Global Economic Impact of Private Equity" http://www.weforum.org/en/media/Latest%20Press%20Releases/PrivateEquity_PressRelease

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- The samples of buy-out transactions that are used for the studies on demography, employment and innovation rely almost exclusively on US transactions. The study on corporate governance covers UK transactions only.

- The findings of these studies thus should be considered within the specific regulatory contexts of the surveyed countries. There remains considerable uncertainty about their relevance in other OECD jurisdictions – not to mention emerging markets – that have different regulatory frameworks notably in Continental Europe, Japan and Korea.

Too narrow a scope on policy issues:

- In engaging in discussions on the employment impact of private equity, trade unions have always stressed qualitative aspects such as wage levels, health care coverage, pension rights, employment conditions, security of employment contracts, rights to trade union membership and collective bargaining. These aspects are left un-answered in the WEF report.

- Similarly, the WEF discussion on innovation is limited to a quantitative approach, looking at the number of patents submitted by private equity firms. On the contrary TUAC has long argued for a broader approach to innovation to encompass the quality of patents and importantly human-resources and skill-upgrading capacities of firms.

- The report also takes an excessively narrow view on corporate governance. In addition to its UK-focus, the study is restricted to a discussion on board composition and leaves aside fundamental governance issues such as reporting and transparency (of the portfolio company, of the private equity firms & funds), the rights of workers and of creditors, and the risk of insider trading and conflicts of interest during a private equity takeover bid.

Theoretical issues:

- The theoretical foundations of the studies seem to tilt heavily in favour of the US-originated “nexus of contracts” theory of the firm, as seen in the multiple references to Michael Jensen’s work in the 70s and 80s.

- While the nexus of contract theories may be considered by some as intellectually challenging, they alone cannot form a valid theoretical ground for today’s global private equity phenomenon. Alternative models and theories exist, including the British schools of thought around the “stakeholder” approach to corporate governance – such as the academic work of John Parkinson. Unlike Jensen, the stakeholder approach recognises the diversity of corporate governance regimes and acknowledges the specific investment and risk and hence the governance rights of other stakeholders than shareholders, including workers.

TUAC and the Global Unions will be cooperating with the authors of the study to strive to shed more light on these issues in the months ahead.