PRIVATE EQUITY AT WORK
When Wall Street Manages Main Street
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Figure 1.1 The Structure of Private Equity: Firms, Funds, and Portfolio Companies

General Partners, Private Equity Firm

Limited Partners
- Pension funds
- Endowments
- Wealthy individuals

Private Equity Fund 1
- Equity investment (30 to 40 percent of price)
- Capital gains (asset sales, dividend recapitalizations, resale)
- Debt service (interest, principal)

Private Equity Fund 2
- Equity investment (30 to 40 percent of price)

Portfolio Company 1
- Loans (60 to 70 percent of price)

Portfolio Company 2
- Loans (60 to 70 percent of price)

Credits
- Banks
- Bondholders

Stakeholders
- Managers
- Workers
- Suppliers
- Communities

Source: Adapted from Watt 2008.
Private Equity Business Model

• Debt is lifeblood of the PE model
• Low risk, high reward for PE firm partners
• High risk strategy for portfolio companies
• Speculating with other people’s money
• Taxpayers subsidize PE returns
Two Routes to Extracting Value

Capital structure $\rightarrow$ Strategy $\rightarrow$ Enterprise outcomes

- Debt level
  - Lo
  - Hi
- Operational improvements
- Financial engineering
- Sustainability, Employment

Financial engineering

Lo $\rightarrow$ Operational improvements $\rightarrow$ Sustainability, Employment

Hi $\rightarrow$ Financial engineering $\rightarrow$ Sustainability, Employment

+ $\rightarrow$ Sustainability, Employment

- $\rightarrow$ Sustainability, Employment
PE & Operational Improvements: Aidell’s

Aidells’ Sausages

- Small family-owned iconic SF firm
- PE provides resources for growth
Asset Stripping at Red Lobster

Red Lobster
- Large restaurant chain
- Sold by Darden to Golden Gate PE in 2014
- Golden Gate immediately strips assets
Investors as Employers & Managers

Mervyns Department Store

- Iconic California Company
- 30,000 workers lost jobs
Investors as Labor Negotiators

Energy Future Holdings

• Texas utility
• Largest buyout ever - $48 billion
Quantitative Effects on Workers & Pensions

• Higher Bankruptcy Rates

• Lower Employment and Wages

• Mediocre Returns to Pension Funds
PE and Dumping Pension Liabilities

Scott Brass

• Sun Capital

• Pension liabilities in bankruptcy case
PE-Driven Bankruptcies

Friendly’s Ice-Cream
- Fast track sales in bankruptcy
- Pension fund liabilities shifted to PBGC
Recent PE Bankruptcies

- Archway & Mother’s Cookies (2008)
- Linens ‘n Things (2008)
- Mervyns (2008)
- Extended Stay Hotels (2009)
- Reader’s Digest (2009)
- Anchor Blue Clothing (2009, 11)
- Stuyvesant Town and Peter Cooper Village (2010)
- Simmons Mattress (2010)
  - Uno’s (2010)
  - Friendly’s Ice Cream (2011)
  - NewPage (2011)
- Coach America (2011)
- Harry & David (2011)
- Golden Guernsey Dairy (2013)
- Energy Futures Holding (2014)
- Caesar’s Entertainment (2015)
Net Effect on Companies, Jobs, and Wages

PE owned companies and bankruptcy rates
- Have 2x annual bankruptcy rate of publicly traded companies
- Bankruptcies often lead to large pension losses
  (Source: Stromberg 2008)

PE-owned companies and job and wage losses
- PE typically buys better performing companies
- Post-buyout: PE owned establishments had 3.2% lower job growth after 2 yrs.; 6.4% over 5 yrs.
- Wages fall relative to comparable publicly traded companies
  (Source: Davis, Haltwinger et al., 2011)
PE Hasn’t Beaten Stock Market Since 2005
(PitchBook 3Q2015 Benchmarking Report)

When using a KS PME, a value greater than 1.0 indicates outperformance of the public index (net of all fees). For example, the 1.13 value for 2005 vintage PE funds means investors in a typical vehicle from that year are 13% better off having invested in PE than if they had invested in public equities over the same period.
Smart Regulation

• Increase transparency

• **Limit leverage** to limit risk to workers, creditors, others

• Discourage financial engineering

• Close tax loopholes
  – Carried Interest
  – Management Fee Waivers
  – Monitoring Fees

• **Update employment, bankruptcy, & pension laws**
  – WARN Act, 363 bankruptcies, ERISA