Private Equity & Its Impact on Employees & Management

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1. Introduction

Private Equity (PE) is a niche market and a rather complex private market; nevertheless, it is a term of great interest which can provoke emotions from admiration to fear. The PE industry has seen incredible growth the last 20 years (Tykvová, 2018), and despite turbulent years with Covid-19, casting shadows upon the world economy, 2021 was another extraordinary and record-breaking year for the PE industry.

As PE continues to blossom, it has become an important mechanism to restructure organisations around the world (Bacon, Wright, Scholes and Meuleman, 2012). However, as PE has become a global hot topic, it has given birth to a political economy debate on understanding the increasing significance of financial market institutions, their influence on corporate governance and the potential transition to a new stage of financial market capitalism or fund-driven capitalism (Ibid). Research has found that financial market institutions' operations, specifically PE, appear to influence the conduct and outcome of employment relations. The raised debate especially goes on whether this alternative organizational form, created by the PE industry, is capable of effectively developing and motivating employees to improve organisational performance or it rather contributes to increased corporate restructuring and employment insecurity (Ibid).

In spite of the growing interest in private equity and the emerging area of research, the literature on the subject is rather sparse and the effects on employees are inadequately understood (Agrawal and Tambe, 2016). The main reason behind can be found in the name i.e., Private Equity; PE has historically been a secretive economic sector, since it operates privately and is not required to disclose reports of what it does and how it does it (Jain and Manna, 2009). Thus, the data on the subject has been slightly limited and often not available to the public. Therefore, the aim of this paper is to strengthen the current literature specifically through a case study that investigates PE and its impact on management.

2. Research Objective

The following research question has been chosen based on previous research on the subject and in order to add to the current literature:

How does Private Equity impact employees and management?

This paper will use a qualitative approach and build on prior studies on the area through an in-depth analysis of three PE buyouts at different points in time made by Polaris Private Equity (referred to as "Polaris" going forward). Polaris is a Danish leading middle market firm focused on buyouts in the Nordic Region. To address the question, the research will inspect the question from three different perspectives: from the view of the employees in the three buyouts; from the management in the three buyouts; and lastly from the perspective of the management in Polaris.

3. Empirical Background

To understand the significance of the proposed research, it is evident to understand what private equity is due to its complexity and the evolution of the phenomenon.

What is Private Equity?

The most defining feature of PE, and what sets it apart from traditional investment assets of stocks and bonds as well as the other alternative asset of hedge funds, is that a PE fund only invests in private companies (Metrick and Yasuda, 2011). There are four main subclasses of PE with the two largest and most significant being venture capital (VC) and buyouts (BO). Secondly, PE funds are financial intermediaries that raise capital from investor, in which there are different organisational forms. The limited partnership structure is frequently the favoured organisational form. PE firms act as general partner (GP) who make and manage investments. Investments made from capital collected through investors (such as pension funds, endowments, insurance companies, family offices and other, mostly institutional, investors), who act as limited partners (LPs). Thirdly, another central feature of PE is that a PE fund actively monitors and assists its portfolio companies – potentially a key determinant of a PE funds' performance (Ibid). Fourthly, the primary goal of PE is to maximise financial return through exiting investments often in the form of an IPO (initial public offering) or sale to a larger corporation. Lastly, a PE fund has a finite life, classically 10 years, in which the PE firm normally has up to five years to invest the fund's capital in companies, and an additional five to eight years to return the capital to its investors (N. Kaplan and Strömberg, 2009).

The Evolution of Private Equity

Private equity was initially an American phenomenon. PE investments date back to the beginning of the Industrial Revolution, when affluent individuals and families invested in railways and other industrial enterprises (Lerner, Leamon and Hardymon, 2012). Furthermore, by the end of the nineteenth century and start of the twentieth century the before mentioned individuals had established offices to manage their investments (Ibid). In 1946, the first two formal venture capital firms were established: American Research and Development Corporation (ARDC) and J.H. Whitney & Company. The first decades of PE never saw an overwhelming annual flow of money into the industry – less than a few hundred million dollars was committed to the industry (Ibid). However, activity increased remarkably afterwards. The PE industry saw a great boom during the 1980s, 1990s and much of the 2000s. In 1991 investors committed less than $10 billion (N. Kaplan and Schoar, 2003); in the early 2000s more than $500 billion was committed to PE, and by 2007 it had exceeded $1 trillion (Bain & Company, 2021). Activity increased especially due to the rise of limited partnership as an organisational form and the creation of a high-yield bond market, which enhanced the availability of debt. Additionally, the information technology related industry created extraordinary opportunities, resulting in PE firms starting to back world-changing companies, such as Apple, Intel, Microsoft and Google, contributing to making the PE industry more influential (Lerner, Leamon and Hardymon, 2012). For instance, Kleiner Perkins bought 10% of Google for $12.5 million which in 2004 turned into $4.3 billion or approximately 344 times its original value (at this point, Google's market value was some $141 billion) (Ibid). Furthermore, diving deeper into the increasing presence and success of PE, the industry has since then only thrived. As can be seen in Figure 1, the PE industry has the last decade set new records every year. Furthermore, despite turbulent years with Covid-19 and its global fallout, the PE industry has continued setting records of $2.6 trillion in 2019 and $2.9 trillion in 2020 (Bain & Company, 2021).

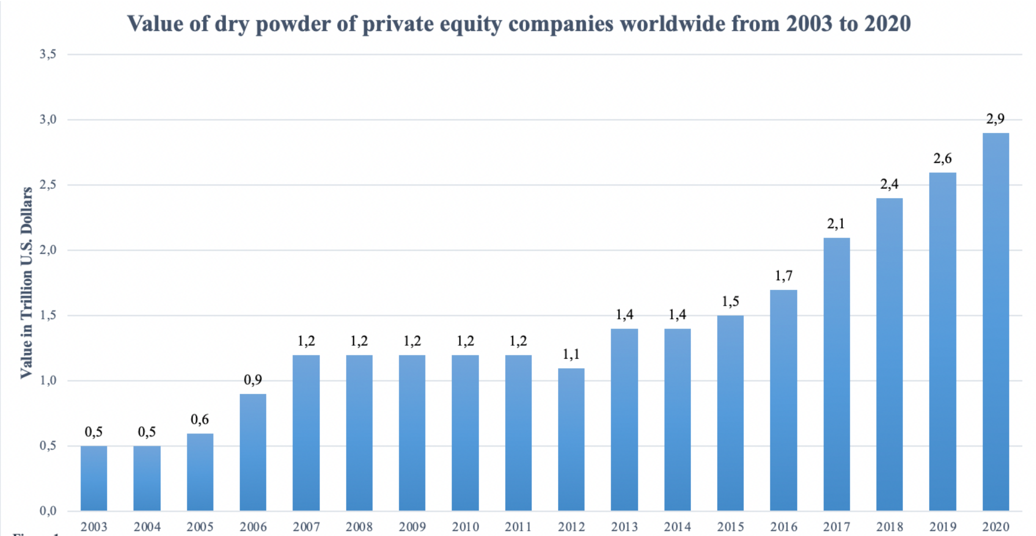

Figure 1
Source: Bain & Company (2021)

Note: "Dry powder refers to the capital which a company has committed to invest, but has not yet allocated." (Statista, 2021)

4. Theoretical Background/Literature Review

The following literature review seeks to situate the subject within a relevant line of former research. Based on prior work, the proposed research design will cater towards conclusions obtained by previous scholars. More recent papers will appear; however, since there is not a multitude of public research and data on the subject due to the industry being rather secretive, less recent papers will also appear and serve as backbone to this discussion.

PE & Deal Management

At the simplest level, PE firms are active investors who strive to enhance the performance of underperforming companies. This is typically accomplished through deal management where they seek to refine the company's strategic focus and improve the quality of management decision-making, which often includes laying off and/or recruiting more competent managers (Bacon et al., 2012). The research of N. Kaplan and Strömberg (2009) found that financial, governance and operational engineering are three types of changes that PE firms apply to companies in which they invest. Once a PE firm invests in another company, the GP's simply do not walk away and let the company run itself (Lerner, Leamon and Hardymon, 2012). On the contrary, PE requires deal management – active intervention. Deal management is a key feature that distinguishes PE from other investing types; the benefits of equity investments are centred on creating value which is created through deal management and governance (Ibid). Thus, it allows investors to intervene and execute strategies if a portfolio company is doing poorly.

Another key feature of a PE deal is that the management's equity is illiquid, meaning the management team cannot sell its equity (N. Kaplan and Strömberg, 2009). Typically, the management team is provided with a significant equity upside through shares and options, in which the PE firm further requires the management to make a consequential investment in the firm. Consequently, the management team not only has a large upside, but also a large downside. This feature protects investors on the downside, while it reduces the management team's incentive to manipulate short-term performance and instead encourages them to act and operate in the best interests of owners, focusing on profits rather than other agendas (Goergen, O'Sullivan and Wood, 2014).

PE & Employees

In the last 30 years several papers have analysed PE and its impact and consequences on employment, productivity and wages. The debate takes two opposing sides. On one side, critics accuse the PE industry of representing the apex of predacious financialised capital, focused on short-term financial performance for a "quick sale" at the expense of other stakeholders, notably employees (Bacon *et al.*, 2012). According to this view, PE is argued to focus on revitalising short-term profits rather than investing in management practices that build long-term value. On the other side, PE is reasoned to revitalise and unlock hidden capabilities and value by utilising equity incentives to realign the interest of owners and managers, which motivates managers to cut unnecessary expenses and avoid value-destroying activities or low-benefit investments (Ibid).

Davis, Haltiwanger, Handley, Lipsius, Lerner and Miranda (2019) made a research based on tracking thousands of PE buyouts from 1980 to 2013 and building on data and analysis from an earlier study they did in 2014. The study found that the effect of PE on employees and management vary a great deal depending on the type of deal and market conditions. The research found that buyouts of public-to-private led to employment loss of 13% over a time span of 2 years; however, buyouts of private-to-private expanded employment with 13%, both compared against control firms. Thus, the research both provided evidence to PE buyouts leading to both job losses and jobs gained. So, they raised the question as to how essential the type of buyout is to achieve productivity gains, and if so, is this trade-off acceptable (Ibid)? The research did as well find that productivity increases by 7.5 percentage points, but the compensation of workers decreases by 1.7 percentage points. As the study points out, wages have for a long time been a controversial matter, in which critics argue that PE led to lower wages. Davis *et al.* (2019) study did find evidence to support this claim, as well does the research of Lichtenberg and Siegel (1990), a database of +20.000 leverage buyouts (LBO) extracted from the U.S. Census Bureau's Longitudinal Research Database linked to a list of LBOs provided by Morgan Stanley and Co. Their research reported that buyouts led to lower wage levels for white-collar workers.

Despite research giving evidence to the harmful consequences and impact of PE on employment, the research is not one-sided as Davies *et al.* (2019) exemplified. The impact of PE is rather complex and miscellaneous. The research of Bacon *et al.* (2012) found there is stronger archival data that does not support the critical views. Instead, based on more systematic tracked research, the impact of PE suggests that employees benefit from more secure jobs and potentially greater employment as a result of lower agency costs, stronger strategic and operational skills, and therefore more sustainable businesses (Ibid). According to these studies, a decline in employment in private equity-backed buyouts is followed by a rise in employment. Furthermore, the more recent research of Agrawal and Tambe (2016), following an LBO, suggest that PE improves human capital in other ways typically ignored in policy debate. The research found that the understanding of information technology increased employability and wages in the long-run relative to what they would have realised without the PE investments. Another significant factor is that of productivity, in which Davis *et al.* (2019) found that productivity levels increase primarily due to greater revenue growth and in a few cases due to redundancies. Additionally, Davis *et al.* (2019) research reported on two case studies which found that PE firms increased productivity levels through lowering operating costs, rationalising rental facilities and replacing the management team with a more competent one.

Conclusion

The literature review outlines some of the most significant research on the area of PE and its impact on employees and management. Research has predominantly focused on PE has impacted employability, productivity and wages. Additionally, the literature review proposes that PE has had ambiguous effects, while the studies reach different conclusions. Furthermore, less research has focused on PE has impacted the management and the difficulties and implications that follows as well as little on the matter of corporate culture. Thus, it is yet to be a saturated field of study, which creates great opportunities for further research and testing of earlier findings.

5. Proposed Research Design

This final part of the research proposal will outline a propositioned research design. The methodological strategy of the research proposal takes the form of comparative case studies on three buyouts undertaken by Polaris to compare similarities, differences and patterns across the three cases. This will be done utilising a qualitative approach for data collection and analysis.

5.1 Population & Unit of Observation

This paper intends to study how PE impacts the employees and management of firms acquired by PE firms. Specifically, the objective is to study three buyouts made by Polaris in great detail. Polaris has more than 48 buyout cases, of which they have exited multiple; hence, to make the framework feasible and reasonable the units of observations have been limited to three buyouts. The three buyouts should not be too far in the past in order to avoid recall bias (Bacon *et al.*, 2012). Furthermore, Polaris' primary market is the Nordic Region, and the three buyouts should encompass buyouts from three different countries. This constraint is intended to increase reliability, as the corporate culture of enterprises may influence employees differently, perhaps leading to ambiguous results.

5.2 Sample Selection

The study sample frame intends to include diverse perspectives on how the buyout of Polaris has impacted the employees and management of the specific target firm. This is important in order to get a comprehensive and holistic picture of the implications, consequences and general effects. Thus, the research proposes to conduct interviews with the three target firms, but it will also conduct interviews with GPs and LPs from Polaris. The proposed research design will utilise a quota sampling method in which interviewees from Polaris and the three target firms will be divided into three groups based on their characteristics. The sampling frame will include perspectives from the three following groups; i) members of the management team in each target firm who has a degree of decision-making authority; ii) employees from each target firm; iii) GPs and LPs from Polaris who have influence on activities and decision-making in one or more of the three target firms.

5.3 Data Collection

The proposed research design will draw on semi-structured, open-ended, face-to-face interviews with the aforementioned sample groups. There will randomly be invited two representatives from sample group (i) and (ii) in each target firm, that is 4 in total from each target firm, to take part in face-to-face interviews in person. If in person is not possible, it would be completed through a video conferencing software. Furthermore, there will be two representatives from Polaris for each target firm, that is 6 in total, to engage in face-to-face interviews. In this regard, it is very important to emphasise the importance of ethical research conduct (Bolderston, 2012). It is important to inform interviewees of the risks and benefits of participating, as well as the option to be anonymous. This might give confidentially to be more informative and decrease the potential of biased answers, which is in the interest of both parties. Lastly, interviewees should be recorded with the consent of interviewees for the post interview process.

The objective of the interviews is to gather information on how the management and employees have been impacted by the entry of the PE firm, Polaris. Thus, the interviews will be conducted with the help of prepared interview guides, of which it will feature open-ended questions to encourage interviewees to elaborate on questions and parts that they feel especially relevant. Likewise, the interviews will be semi-structured to allow for spontaneously generated questions during interviews to give the opportunity for clarification on issues. A semi-structured interview allows for openness and flexibility which can be considered advantageous for exploratory research.

Questions will vary depending on the sample group interviewed; however, they will be structured around the same motives to allow for comparable results between the three different case companies. (Group i) Employees of the target firms will be asked into how, when and where they have been affected by the entrant of the Polaris. What the pros and cons have been, and what actions they see have been taken from the management (of both target firm and Polaris) to manage the human and operational integration process. (Group ii) Members of the management in target firms will be asked more into how they have been affected by the buyout on a daily to strategic level, what implications and consequences they have faced, and what actions they have taken to manage the human and operational integration process. Lastly, questions for the GPs and LPs from Polaris (group iii) are aimed at providing insight into the integration process from the PE firms perspective. More explicitly, how they manage the process, how active they are in it, and which processes they especially engage actively in, as well as how they manage complications. Thus, the interviews have the motive of including diverse and a more complete view on the integration process.

5.4 Data Analysis

The overall goal of the qualitative data is to reach some inferences, lessons or conclusions on how PE has impacted employees and management. Accordingly, it will be important to proceed systematically to condense the large amounts of data into smaller, more manageable chunks of intelligible information. The first step will be making transcripts of the recorded interviews together with notes on non-verbal behaviours and interactions that may be relevant to analyse. Next, the data should be examined, and comparable concepts will be grouped into subcategories which then can be grouped into main categories. This will result in a road map that can be utilised to communicate the essence of the research.

5. 5 Limitations

It is important to be aware of the limitations the proposed research design has and how it may interfere with the reliability and validity of the research, but also provides opportunities for further research. Firstly, the sample size of the research is relatively small, which the time limits of a Bachelor thesis may justify. Furthermore, a different set of employee-groups and geographical locations has been chosen to prevent this; nevertheless, it is important to highlight that the sample size may compromise the findings dependability and validity of the findings. Secondly, it could be argued that the research suffers from response bias, in which the interviewees may want to present their management practices and capabilities but also firm in a positive light. However, as addressed earlier confidentiality will be stressed to counter this, as well as looking for consistency and general patterns of the three different target firms. Other limitations of the research design must also be pointed out. Lastly, it should be mentioned that despite taking all one's precautions and choosing target firms that have had time for changes in management practices to occur, the research may not provide the results needed, and further longitudinal research is needed to track the process of changes over time. Conversely, this exploratory study can be useful for future studies on the subject to test its validity.

5.6 Time Schedule

The proposed time schedule is outlined below. Due to the time-consuming nature of the process and to accommodate for any potential delays, a significant amount of time is made aside to conduct interviews and do analysis.

January:	Preliminary research on private equity buyouts and relevant literature. Final research question formulated. Structure on interviews and initial writing begins.
February:	Begin data collection by conducting interviews with Polaris and buyouts.
March:	Complete data collection and instigate data analysis.
April:	Complete data analysis and outline results, discussion and conclusion.
May:	Unforeseen problems addressed. Complete writing and extensive review of the thesis.
June:	Thoroughly proof-read, make final adjustments and hand-in of the thesis. Begin preparation for oral defence.

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