Private Equity in the UK context

Glenn Morgan
Warwick Business School
University of Warwick,
Coventry CV4 7AL
UK

glenn.morgan@warwick.ac.uk

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Abstract

Private equity has been accused of being 'locusts' destroying the value of companies and changing employee work conditions for the worse whilst extracting vast sums of the benefit of a small number of individuals and institutional investors. The industry defends itself by claiming that its particular form enables firms to overcome the agency problem and in this way managers can manage companies in a much more focused and effective way. This paper concentrates on private equity in the UK. It argues that private equity is the latest of a series of ways in which finance and the City have dominated the UK economy. Its rapid expansion relates to changed global conditions and to the internal dynamics of the UK economy. In a relatively short period, large PE deals became significant in the UK. They led to organizational restructurings which were not very different from those that characterized previous periods of financial activism in terms of how they treated the workforce – as expendable costs. The rise of private equity led eventually to political opposition and although this appeared briefly to be very powerful, in the end it achieved little because it was never strong enough to combat the allied forces of the City, the Treasury and the Bank of England. In fact the only tangible outcome of these political debates was the minor element of reform on transparency which the industry itself produced. However, private equity has not been triumphant. On the contrary it is fully implicated in the current financial crash and its structure means that its growth has ceased and its very survival is in question. In some European countries, this may mean that rising financialisation will be halted at least temporarily. However in the UK where the City is powerfully entrenched, private equity may decline but it is doubtful whether the financial dominance of the UK economy will be fundamentally challenged.

Introduction

In the decade leading up to the financial crisis beginning in 2007, a number of seemingly new actors in the financial markets took centre stage. The two most notorious and controversial were private equity and hedge funds. This paper focuses in particular on private equity. For some, private equity firms are 'locusts', intent on extracting value from existing firms and placing the bulk of that value in the hands of a small number of partners at the expense of the jobs, work conditions and pension rights of employees in the firms taken over. One UK trade union officer, for example, recently stated that 'employees' pay and conditions invariably suffer' under private equity owners (People Management 21/08/08 p.20). For others, private equity performs a useful function, enabling the restructuring and reorganization of poorly performing firms and over the medium term, providing more secure employment opportunities as well as delivering good returns to their institutional investors. .

This paper aims to provide a perspective on these debates from the midst of the current financial crisis. The paper examines the development of private equity in the UK context. It is divided into the following sections. Firstly it focuses on the relationship between financial markets and firms in the UK economy. In the literature on 'varieties of capitalism', the UK is seen as an economy in which firms are dependent on the financial markets for their survival and this drives a particular form of strategy – towards the search for shareholder value. By placing the growth of private equity (PE) into this broader historical perspective, elements of continuity and change are revealed in ways that facilitate a clearer overall evaluation of the impact of PE in the UK over the recent period. Secondly, the paper provides some descriptive data on the recent development of PE deals in the UK. Thirdly, it examines the growth of opposition to PE in the UK context and the basis of this opposition. The paper looks at how far this opposition achieved any changes in the operation of private equity. issues and how PE itself responded to the criticisms raised. Finally, the paper examines how PE is developing in the current financial crisis. It is argued that this reveals quite clearly that whatever its other causes, effects and impacts, private equity is basically a creature of the recent phase of financialization (Erturk, Froud, Johal, Leaver, & Williams, 2008; Froud, Johal, Leaver, & Williams, 2006) As this phase of financialization has effectively collapsed so we can expect the private equity balloon to slowly and painfully deflate; the timescale of this, however, is likely to be drawn out and we may expect that there will be some difficult crises in this exit period where new concerns may come to the fore.

Finance and industry in the UK context

There is a long history of debate about the interaction between finance and manufacturing in the UK context (Ingham, 1984). The origins of the City of London and its financial markets predates the industrial revolution (Kynaston, 1994). The central concern of the City of London has been on maintaining its role as a centre for international financial markets through various phases of the global economy. To sustain this position, the actors in the City have generally been supportive of a stable monetary regime, preferably associated with a strong pound, low interest rates, low government debt and low inflation.

In the 19th century, these conditions helped the City of London to become the centre of international financial markets, a process aided by the wealth of empire. Although there have been substantial changes in the world order since the 19th century and the City's position in international financial markets has ebbed and flowed, it has broadly retained its attractiveness to international investors, thus feeding funds that flow through City institutions providing interest, commission, fees and opportunities for trade and liquidity. At various times, in spite of sharing a commitment to the capitalist order, this has placed City interests against the interests of manufacturing in crises such as those over the value of sterling, the size of state expenditure and the impact of these on employment.

Part of the City's attractiveness was that it basically ran its own affairs, engaging in various forms of private self-regulation with weak oversight on the part of the state (see, for example the discussion of the transformation of this system in Moran, 2003). In order to attract international investors, the City used this lack of regulation to innovate and create new products. In contrast to other countries, therefore, the UK was characterized by a strong financial interest, based on free, open and unregulated markets. Its banking system never had a strong commitment to the funding of industry; it lacked both the large industrial banks and the smaller publicly owned cooperative banks that characterized most European economies. British companies were unable to rely on long-term funding from banks and instead were dependent on raising capital from the financial markets. This made them dependent on the City even though the City's view of the world was disconnected from that of manufacturing industry. On occasions, the two views came into conflict but over the long term, British industry shrank both in terms of size and influence whilst the City, although it went through periods of stagnation and decline (such as the 1930s through to the mid 1950s) remained a powerful force in the British system.

From the late 1950s, manufacturing industry found itself increasingly subject to the machinations of the City. This was most obvious in the market for corporate control which arose as firms quoted on the stock exchange found themselves subjected to acquisition and takeover bids. Over the period from the late 1950s through to the 2000s, the market for corporate control involving UK firms quoted on the London stock markets has outstripped anywhere else other than the US. The market for corporate control and this development reflects a number of key interests within the City context (for some of the most astute analyses of these changes see the books by former practitioners Augar, 2000, 2006; Golding, 2001). Firstly, this market is fee-based and these fees are high value. It is therefore highly profitable for a banking institution to be involved in M+A activity because of the fees involved for advice but also the whole raft of associated fees which can be gained, e.g. associated with underwriting loans. Secondly, this market reflects the influence of shareholders, the ultimate deciders of the outcome of M+A activity. Shareholders generally gain an immediate boost for their earnings in M+A situations since the shares of the acquired firm are generally priced generously by the potential acquirer. Thirdly this market reflects the growing aspirations of managers to run large companies and gain commensurately in terms of their own rewards. The least influential actors in this process are the employees of the firms involved in the M+A. Until recently they have limited employment rights or rights to information and communication. Another aspect of this is that such processes have increasingly disrupted any long-term investments in new products by leading both to frequent organizational restructuring and to frequent changes in personnel, teams and locations (Froud et al., 2006).

It is for these reasons, therefore, that the UK has been labeled as a liberal market economy – one in which firms are dependent on financial markets for their survival, forcing them in to a relatively short-term orientation to investment coupled with an active process of relating to financial markets and their shareholders (Soskice & Hall, 2001) – a process which leads to frequent organizational restructuring and instabilities. How this relationship is actually managed, however, depends on specific circumstances in terms both of the internal dynamics of the UK and of the global economy (see, for example, the analysis of how the UK changed under Thatcherism and the impact on its form of capitalism in Schmidt, 2002). More particularly, the dominance of finance increased in the UK in the 1980s and 1990s. Clearly this was partly a matter of the political dominance of Thatcherism with its emphasis on deregulating financial markets, privatization, encouraging individual share ownership, personal pensions, and home ownership. Associated with this was a growing focus on shareholder value and delivering value to shareholders as an increasingly dominant force (Froud et al., 2006). This reduced management's ability to cross-subsidise in order to provide time for businesses to grow. It made it practically impossible to build up stores of capital within the firm as such capital became attractive to potential predators. It made it difficult for firms to invest in long term innovation processes. Shareholder value was built on the idea of short term profit maximization and distributing this back to shareholders in the form of dividends or increasing the value of stocks through, for example, buy-back schemes. Although unions fought against this and critics argued that this was leading to the deindustrialization of Britain, the City grew in power, wealth and influence.

This growth was not uninterrupted. The global economy continued to have booms and slumps and by the second half of the 1990s, there were increasing crises in parts of the financial system (such as in the Asian financial crisis). The dot-com boom and crash followed soon after by the ENRON collapse led to demands for more regulation, particularly in the US where the Sarbanes-Oxley Act introduced new measures on corporate governance, a trend which was followed in a minor way in the UK. For those who continued to support market mechanisms, these changes fuelled the skepticism of some authors which had been brewing since the 1980s about the effectiveness of public corporations. By the late 1980s, Jensen, a Harvard financial economist, was discussing 'the eclipse of the public corporation' (Jensen, 1989). In this view, public corporations were becoming subject to too much regulation and to many conflicting and competing demands through shareholders, media discussion and public debate. One possible solution was to take the corporation out of the public arena and make it a private company. If it was private, then in theory, decisions could be reached more quickly and implemented more effectively. Thus funds that had previously been steered towards supporting merger and acquisition activity on the public markets began instead to flow into private equity. In this respect, private equity was the latest adaptation of the City to the politics and economics of extracting capital through financial means. Whilst private equity was not new in its form, it was new in terms of the scale of its significance for the broader economy in the period 2002-2007. Many of its impacts were similar to the impacts of the M+A booms that had occurred in the UK in the mid 1980s and late 1990s but because of the specific form of PE and the specific political and economic context of this period, the result has been a new twist in the relationship between finance and industry in the UK context.

The nature and growth of Private Equity in the UK context

Between 1995 and 2007, 15652 firms received private equity fund funding according to the BVCA ((BVCA, 2007b; 58). Over the period 2001-2007, roughly the same number of UK companies (around 1300) received PE funding each year. However these figures conceal the increasing importance of a small number of mega-deals and associated with this a significant increase in the amount of capital employed in the deals. In its analysis of annual trends, the Centre for Management Buyout Research at Nottingham University has shown that although the number of buyout deals in the UK has remained fairly constant, the total amount of capital invested has increased massively from less than £10 billion in 1995 up to a peak of £45.9 billion in 2007 (www.nottingham.ac.uk/business/cmbor). A similar pattern appears in European private equity in that the number of deals hovers between 1200 and 1500 between 1997 and 2007 but the amount of funds invested increases over four fold in this period with the largest leap occurring between 2003 and 2007 (Jenkinson, 2008). What these figures indicate is a significant change in the nature of private equity investment in the period 2003/4- 2007. This is reflected also in the figures published in the UK House of Commons report on private equity which show that large buy-out (and buy-in) deals (i.e. over £50m) increased in numbers from 67 in 2000 to 90 in 2006 and most of this increase arose from deals in the largest category (over £250m) occurred in the period from 2004 onwards (House of Commons Treasury Committee 2007). By 2007, deals involving 67 (out of the total 1330 companies which received PE that year) accounted for 5% of the total number of deals but 76% of the total funds invested. Of these mega deals, in 2007 28 private equity owned firms met the following three size criteria (which were established by the Walker Committee); their enterprise value was greater than £500m, their UK employment was more than 1000 full time equivalents and more than 50% of their revenue was generated in the UK.

The Treasury Committee estimated that by 2007, 8% of the UK's workforce (1.2 million workers) was employed in private equity owned firms and 19% either work in or used to work in private equity owned firms. In terms of sectors, in 2007, firms in consumer services (food and drug retailers, general retailers, media and travel and leisure) constituted 21% of all PE investments and 51% of total amount invested (BVCA 2007: 15-16). Industrials also constituted 21 % of the number of investments though their value was only 17%. Private equity owned firms constitute a significant part of the UK economy. Their names constitute some of the most well-known brands on the British High Street, e.g. Alliance Boots, National Car Parks, New Look (clothes retailer), Odeon and ICI Cinemas, Phones4U, Somerfield, Travelodge, Weetabix, the AA.

The growth of private equity in the UK reflected both the changed global context and the specific conditions of the UK. In relation to the global context, the period from the mid 90s up to 2007 was characterized by high levels of investment capital seeking outlets in alternative asset classes from company stock and shares and government bonds in a context where interest rates and inflation were relatively low. This capital was available firstly because of a global imbalance of trade which left resource rich countries and China in particular holding dollars that required to be invested; secondly because of high savings rates in certain countries associated with a combination of demographic forces and particular forms of pension arrangements; thirdly because the development of securitization processes and markets enabled banks to move lending off their balance sheets almost as quickly as they did the actual lending and in this way to lend again; fourthly because the army of intermediaries in the financial markets earnt fees on the number and scale of transactions and were therefore active in creating markets for these securitized bonds. As is now clear, this created an environment of high liquidity where loans were easy to get hold of because lenders were able to quickly pass on the risk of the loan through the financial markets. Private equity depended on these easy lending conditions and high levels of liquidity because it depended on double form of leverage; on the basis of a relatively small initial financial commitment of the partners in the private equity company, it could gain access to massive funds in this market context. Thus it was relatively easy for much of this period for private equity to raise the other 70% of capital needed to supplement their own existing funds and enable them to purchase companies.

In terms of specific UK conditions, the City of London contained large numbers of international banks and investors which sought to participate in this process. The banks were able to organize the loans necessary for the high levels of leverage required by private equity. International investors were used to working in the City; they were keen to find new asset classes which could bring higher returns than normal stock market investment which was increasingly becoming pre-programmed and index linked. The political, regulatory, employment and tax environment was favourable to the private equity model. Private equity firms had been established in the UK for some years before this boom and had well-established track records, organizational infrastructures and managerial competences. The UK also had well-established financial markets that enabled viable exit options for private equity investments though, for example, initial public offerings. Alternative exits were also feasible in the UK, e.g. because of the high concentration of private equity funds, the possibility of selling an investment from one PE firm to another was always possible. Similarly the mechanisms for making trade sales, i.e. selling off a PE investment to another company was also easy to accomplish given the range of linkages which the PE firm and its banking advisers would be likely to have in the broader market. In contrast to most Continental European countries, therefore, this was a favourable environment for private equity firms themselves to set up and expand as well as to engage in acquisitions and sell-offs.

The legitimation for private equity was also well accepted in the UK context. The argument that public companies faced agency problems that could be overcome by creating a board structure that was smaller, more focused and more directly incentivized to increase the value of the firm reflected a broader discourse in which incentives through share options and the performance of shares was an unproblematic part of the self-understanding of the UK financial sector (up to 2008). In terms of the agency debate, private equity ownership did lead to a substantial reorganization of corporate boards (De Cock, Gospel, Jackson, Kirkbride, McNulty, & Morgan, 2007). The boards of acquired companies were much smaller than they had been as public companies. Depending on the size of the acquired company, the private equity firm would put between one and three of its own partners onto the new board as directors. These directors would oversee the PE investment and bring a certain level of expertise, knowledge and networks to the working of the new firm. The rest of the board would also be carefully selected by the PE firm. The Executive Chair and the Finance Director were particularly important appointments. Most PE firms have a pool of senior managers with whom they have worked a number of times. These managers move into a PE acquisition, manage the changes in order to create value and then oversee the exit strategy. They stay for around 2-4 years before moving on and performing the same role in another company. Some of the largest PE firms explicitly recognize this pool and bring them together on an occasional basis to discuss common problems or provide a means of seeking their advice and communicating with them on broader issues besides the fate of the company which they are managing. These senior managers are expected to invest a substantial part of their own personal wealth into the acquired firm and can expect to benefit if the exit strategy is managed successfully. Similarly, where managers from the acquired firm are invited to stay on under private equity ownership, they are also expected to provide capital towards the new company.

It was also undoubtedly the case that some PE funds were able to produce high returns in this period between 2003-2007 as they purchased companies at what subsequently appeared to be relatively low prices, rapidly restructured them (often releasing capital through selling off and leasing bank land as well as reducing employment costs) and were able to sell them back into the rising bull market of the period within a time frame of two to four years at the maximum. In the context of UK capitalism, where firm restructurings driven by the financial markets had been common for many years, the private equity boom was broadly seen as a new and effective variation on finance driven change processes. It was supported by the City institutions, the regulators, the institutional investors and the government (and the Conservative opposition) as a positive gain for the UK economy.

The growth of opposition to private equity in the UK

As private equity grew in importance in the UK, so too did opposition and concern about its effects. The arguments have increasingly focused around the impact of PE on jobs and working conditions and the ‘unfair’ tax advantages of PE together with the size of bonuses and earnings for PE partners.

Private equity and jobs

In terms of jobs, trade unions argued that in many cases where the immediate impact of private equity was to scrap existing employment conditions, cut the workforce, intensify work conditions and reduce benefits. In the early stages, private equity tends to be very focused on cost reduction in order to ensure that it can meet its debt repayment obligations. As authors such as Clark emphasize (Clark, 2007; 2008; see also; Thornton, 2007), private equity management takes advantage of the fact that its purchases do not come under TUPE regulations (because they are considered to be changes of ownership rather than a transfer of activities from one company to another) and often aims to change the conditions of employment in order to intensify work and reduce the influence of trade unions. Private equity also seeks to reduce expenditure on company pension schemes either by switching employees out of such schemes into cheaper, individual alternatives or by failing to fill financial holes that emerge in pension schemes or by transferring pension fund management and obligations to insurers. Other authors point to case study research which reveals the extent to which employment costs are squeezed by private equity management (Froud & Williams, 2007).

These arguments are relatively difficult to substantiate because of the problems associated with getting comparable data over time (Watt, 2008). The most systematic research on this topic has been undertaken by researchers such as Wright and Bacon at CMBOR using a database stretching back to the 1980s. The fairly consistent finding of these studies is that whilst employment numbers drop in the first year of the acquisition, after this they tend to climb slowly if steadily as the company is restructured (Bacon & Wright, 2008). They also suggest that overall there is an increase in what have been described as high commitment HR strategies e.g. more performance related pay schemes, increased team work and functional flexibility, increased training and more job security (Bacon, Wright, Demina, Bruining, & Boselie, 2008). Bacon and Wright, for example, state that 'employees in buy-outs have more discretion over how they tackle their work than comparable workers at other firms…Overall union recognition rates remain unaffected by private equity investors' ((Bacon & Wright, 2008). They argue that these trends are particularly noticeable in cases of what they describe as 'insider' buyouts, i.e. where the existing management of a firm is retained to run the new private equity owned business. Interestingly, Bacon et al. (2008) show that where employment rights are strong such as in the Netherlands, private equity has to adapt to this, whereas in countries like the UK where these are weaker, private equity is freer to get rid of employees or change job conditions in significant ways.

Private equity earnings

The standard model for PE earnings is based on a 2% fee per annum based on funds invested and a 20% return on the extra value created in a sold off company (subject to the achievement of an acceptable 'hurdle rate', usually around 8%). Achieving this return requires a degree of financial innovation and ingenuity at all stages of the process. This begins with keeping the price paid for the company as low as possible. Where the PE partners intend to keep on some of the senior managers of the acquired company, this creates potential conflicts of interest since these senior managers are employed to maximize the price of the company to be sold whilst from a personal point of view, the lower the price the higher their ultimate gain when the firm is sold on by the PE acquirer.

Once the firm is acquired at the high leverage levels discussed, the PE owners look to reduce the debt by selling off some non-core assets. One crucial set of assets which has been defined as non-core has been land and property. Given the boom in commercial property prices in this period, PE firms were able to release large amounts of capital by selling off this asset and leasing it back. This is one explanation as to why consumer services have played such an important role in PE expansion; they generally come with large amounts of retail property that can be subject to this sale and leaseback operation. When the large UK supermarket chain, Sainsburys, became a target for PE acquisition, the value of its property portfolio was seen as a key asset that could be subjected to sale and leaseback, thus quickly reducing the amount borrowed. Most large publicly quoted retailers prefer to retain the control and security that owning their own property gives them; for PE, however, access to the cash is more important. Other financial engineering techniques may be used e.g. renegotiating the debt in order to reduce payments or in order to pay a special dividend to the owners. PE needs a steady stream of revenue in order to service its debt. This is one of the reasons why PE investments tend to go into steady and unspectacular companies, where there is a reliable base of income generating activities. Investing in research and development is unlikely both because it would require diverting funds away from debt servicing and because the industries in which PE is invested are generally not noted for their innovation. The goal of these activities and other efforts to reduce costs and increase revenue is to pay off debt at the most financially opportune moment so that when the exit strategy is fixed, as much of the value of the company as possible is now vested in the shareholders and debts to others have been reduced. Thus potentially large sums are returned to the investors.

In the case of the private equity partners, 20% of the value of a company returned to public markets can create a large pool of money to be distributed amongst a very small number of people creating huge personal fortunes for leading partners. Thornton, for example, states that ‘in the case of successful mid-market funds, six to 10 partners could expect a carry of £5m to £15m after 5 years; for partners in the much smaller number of very large funds, the rewards might be of the order of £50m to £150m’ (Thornton, 2007 21). In the UK, that money has been covered under rules concerning capital gains and investment in business which means that in effect, where the investment has been in existence for more than 2 years, it has been taxed at only 10%, far below the level of income tax. Because it is possible in the UK to claim domicile overseas even when working predominantly in the UK, these inequalities of tax take can be extended further. The *Observer* newspaper claimed for example that only 40 of the top 200 private equity partners were tax domiciled in the UK (17 June 2007). Even within the industry, there was concern about the inequalities that were created. In 2007, Nicholas Ferguson, chairman of the private equity firm CVG Capital, said: "Any commonsense person would say that a highly-paid private equity executive paying less tax than a cleaning lady or other low-paid workers...can't be right" (Times 5 June 2007). Trade unions have been vociferous in their campaign for reform of the taxation system and the increasing inequalities in societies represented by the high earnings of private equity partners.

The politics of private equity

By mid 2007, the concern over private equity in the UK had increased to such an extent that the issue became a political flashpoint. The PE industry itself had recognized that some such storm was coming and its industry body (the BVCA) had sought to circumvent this in February 2007 by setting up 'a review of the adequacy and transparency in private equity with a view to recommending a set of guidelines for conformity by the industry on a voluntary basis'. Sir David Walker, a former Deputy Governor of the Bank of England as well as Chairman of the Securities and Investment Board (the precursor to the Financial Services Authority), was asked to produce the report working with an advisory group of industry insiders. A consultation document known as the Walker Report (BVCA, 2007a) was published in July 2007 and following further inputs the key recommendations were implemented in 2008.

Unfortunately this response from the industry (details of which are discussed later) came too late to prevent the public humiliation to which the leaders of private equity were subjected at the hands of the Treasury Committee in June 2007. The Treasury Committee of MPs took evidence in public from a number of academics, public figures, trade unions and others in which a range of criticisms of private equity were made. Montgomerie et al. studied this process in detail; they state that;

"It is unanimously agreed that private equity industry, the BVCA, and the large-cap funds gave a feeble performance in their oral evidence to the Treasury Select Committee. Poor public engagement fuelled the ongoing media frenzy over the excess of the private equity industry. Combative and ineffectual testimony in front of the committee by the BVCA and General Partners of large-caps led to open animosity in the public hearing" (Montgomerie, Leaver, & Nilsson, 2008; 12)

In the immediate aftermath of the BVCA appearing before the MPs, its executive director, Peter Linthwaite, resigned such was the public criticism of the organization and its evidence. In preparation for their appearance before the Committee the following week, leaders of some of the largest private equity firms in the UK hired public relations experts to try to improve their presentation. Montgomerie et al. argue that private equity did so poorly because it refused to acknowledge that there might be any problems at all with the PE model;

"Essentially the industry body tried to claim that private equity could be all things to workers, investors and the firms they acquire…Perhaps it is no surprise that such fantastic claims were greeted with intense skepticism….Efforts to put forward the multiple benefits of private equity and the universal gains realized by their business activities were ultimately unconvincing because of the lack of corroborating evidence…Alongside the weakness in the evidence the industry suffered from its inability to provide a cohesive and plausible account of business practices" (Montgomerie et al., 2008; 13-14).

However, although there was general consensus about this in the media, the Treasury Select Committee report when it was published was, as might be expected from a bipartisan committee, much more muted in its criticisms and suggestions (House of Commons Treasury Committee 2007). On employment issues, it called for more information and consultation by PE owned companies and asked for ACAS to be involved in facilitating this. It also, strangely, sought for clarification from the government about the application of TUPE regulations to PE even though most participants were convinced that TUPE did not apply. On transparency, the Committee agreed to await the Walker Report recommendations to see if the industry could put its own house in order. On taxation, the Committee was critical and called for more action from the government and the tax authorities to avoid abuse of the system. Not surprisingly, Montgomerie et al describe this in terms of PE 'losing the battles but winning the war'. In the buoyant financial context which existed up to mid 2007 and continued to survive into 2008 even as the financial crisis gathered pace, there was very little government will to take up the issues raised in the Committee discussions, particularly once the Committee itself had been so reticent in terms of suggestions for new regulation.

As a result, the only significant change from these political debates arose from the industry reforming itself and implementing the Walker report. The recommendations from the Report concentrated on the issue of transparency to the exclusion of almost everything else. It had nothing to say about working conditions, trade union rights or taxation issues. Instead it concentrated on public concern that a number of large companies were being taken off the public markets where they were obliged to make statements about their accounts, their strategy, their management and governance and placed into the private sector which required none of this. Similarly it was concerned to counter criticism that PE partnerships which now controlled substantial parts of the UK economy did not have to disclose much information about themselves and their activities since they were private partnership. Walker therefore recommended that the largest PE owned companies and the largest PE partnerships be subjected to some sort of disclosure and transparency regime.

With regard to the PE owned companies, the bar was set very high. Only the very largest companies (over £500m in acquisition price) AND over 1000 employees in the UK AND over 50% revenue generated in the UK were to be subject to this disclosure regime. In the first report following the acceptance of these proposals (Ernst and Young, 2009), this net caught only 28 companies (out of the approximately 26,000 firms in which PE has invested since 1987 according to the BVCA's own figures). These firms were asked to provide audited accounts, to identify their PE owners, share their risk management objectives and provide a business review. The Guidelines Monitoring Group which published its first report in January 2009 was broadly content with the response of the PE owned firms though it noted a number of areas where some firms could perform better, e.g. some companies did not provide full information on their board of directors and detailed quantifiable evidence on employees was limited (Guidelines Monitoring Group, 2009). The PE partnerships required to make enhanced disclosure were those owning companies meeting the criteria for disclosure. This meant that 32 PE firms were required to disclose and whilst again the Guidelines Monitoring Group was generally satisfied, it was nevertheless the case that only 'half of the private equity firms initially met all their disclosure requirements' (p.12).

In conclusion, it can be seen that in spite of huge negative publicity in the period up to and including the Treasury Select Committee hearings, the private equity industry has barely responded to these concerns. It has implemented some relatively minor voluntary disclosure guidelines which have caused it little difficulty. The great bulk of PE owned firms or PE partnerships are totally unaffected by this and there is little indication of what impact, if any, this might have on the companies and the employees concerned. Ultimately opposition to private equity was not sufficiently organized, coherent or powerful to force change on what was a very powerful interest group within the City supported by the UK government as part of the effort to maintain London as a global financial centre. Whether the outcome would have been any different if the financial crisis had not intervened and forced everybody's attention to key questions of system stability and economic viability is difficult to determine.

The Financial Crisis and Private equity in the UK

In the period 2003-2007, private equity was able to achieve rapid gains by a financial reengineering of the company. High levels of liquidity and confidence in the gains to be made from private equity investment and in financial dealings enabled this engineering to become ever more sophisticated. It also speeded up the circulation of capital and different forms of financial instruments in the market leading to a speculative boom in asset prices. This in turn fed back into the valuation of the private equity companies and enabled further financial reengineering. Much of the gains in this period reflected simply the conditions of the boom economy. As shares moved up, more capital (some of it borrowed and leveraged) flowed into the market seeking to capture some of these gains; this in turn pushed the market higher. In these conditions simply holding on to an asset for a time had a high chance of generating a gain for the owner. It was a classic speculative boom that pushed all prices upwards so long as there was confidence that the spiral would continue. Therefore private equity could achieve big gains in the same way other investors were gaining before it had to do anything more complicated to generate value. Within a relatively short period of time assets could be sold via the various exit options and high returns generated, particularly for the private equity partners.

Whatever the gains made through new forms of management and governance, the success of private equity was very much based on its ability to engage in financial management under conditions of high liquidity, low interest rates and rising stock markets. This is revealed very clearly when we consider how private equity has developed since the credit crunch. It is important to note that private equity still retains capital to invest though this is shrinking. When funds were set up in 2006 and 2007, the basis of the investment was that it would be available for ten years. Private equity could use these funds to rescue and restructure businesses being brought under pressure by the credit crunch. However, private equity now finds it practically impossible to find buyers for its debt and therefore it cannot exercise leverage and cannot generate deals. Because it cannot exercise leverage it lacks the possibility of doing the big deals and generating the management fees and 'carry' income that it was able to in the previous period. On 19 December 2008, the Financial Times reported that 'private equity groups invested less that £1bn in the UK market during the past three months, the lowest quarterly figure since 1995…The total value of buy-outs in the UK for the year stands at £19.1bn, compared with a record £45.9bn in 2007…Cash-strapped banks are refusing to lend money for almost any leveraged buy-out except to acquire secure companies in the most defensive sectors. Even when debt is available from banks, it is often expensive." Furthermore, these cash strapped investors are beginning to seek ways to pull their funds out of private equity. On 18 December 2008, the Guardian reported that SVG capital which accounts for almost a third of the private equity company Permira's main fund had cut its commitment by 40% in order to repair its own balance sheet.

The other side of this is that private equity has far fewer options in terms of exiting the businesses which it bought over the last few years. Stock market prices are still falling. There are few firms willing to engage in a trade sale and secondary sales to other private equity firms are stagnant. In effect, therefore, private equity will find it difficult to release funds from existing investments and may have to hold on to them for much longer than was originally expected. It can also be expected that the number of failures will increase amongst the firms purchased by private equity. The IUF's Private Equity Buyout Watch reported on 4 December 2008 that up 'up to half of the companies taken private in the past three years face potentially serious problems with continuing to finance their debt' because of the general downturn in business. The result may be a series of negotiations with lenders including turning debt into equity in order to reduce the burden on fixed repayments. If this happens (and banks are generally resistant to such deals), the result will be to diminish substantially the possible gains to be made by the private equity firm and its investors. In this context, private equity groups with funds to spend appear to be starting to act more like traditional institutional investors in that they are now reported to be buying stocks of public companies though it is unclear how this can justify the fee structure of private equity (the 2/20 model) as opposed to the traditional institutional investment model. Meanwhile they are left in the traditional position of owners of companies during periods of recession; they have to cut costs and sweat assets in a context where markets are weakening. Unwinding these existing assets may prove painful burdened as they are by substantial debt.

These difficulties reflect the fear expressed in a number of sources including regulators and the Treasury Select Committee that the big underlying problem with private equity was the risk factor and the possibility of systemic contagion. The models by which PE worked were based on low interest rates, high liquidity and rising asset prices. This made the 30/70 (shares/debt) leverage structure possible but it meant that if interest rates rose, if liquidity froze and asset prices started to fall, companies would become more vulnerable to failure than if their structure were the other way round (70/30) as tended to be the case in publicly quoted companies. The result is that PEs are locked in to investments for much longer than they expected and it is not clear that these investments will realize the value necessary to pay off the loans, never mind, pay the level of bonuses and rewards which PE received just a few years ago. In these conditions, institutional investors, themselves in difficult positions because of other asset price falls and holes in the balance sheets of their owning financial institutions may look to pull out their money as soon as possible, leading to a spiral downwards. The fact that so many PE funds and PE companies are based in the UK therefore contributes to the speedy decline of the UK economy under the impact of the financial crisis.

From this perspective, UK capitalism is undergoing one of its periodic processes of adjustment though on a far larger and more intense scale than anything that has happened since the early 20th century. Private equity just like the investment banking community more generally is having to work through the consequences of the financial crisis. It is unlikely that the conditions which facilitated its rapid growth up to 2007 are going to return in the near future. This will not stop UK capitalism restructuring but will rather mean that it will do so under new conditions and possibly with new financial actors playing a significant role. One such set of actors may be the banks which have been taken into partial public ownership. It may be that the government will try to use these institutions to establish new relationships between finance and industry. However, this would be to sideline the traditionally powerful forces of the City of London and financial markets and whilst they are currently cowed by the severity of the crisis and the scale of public disapprobation, these forces tend to find ways to resurrect themselves and their powers.

Conclusion

UK capitalism has long been based on the dominant position of finance. Over the last 40 years, finance has driven rounds of organizational restructuring in British industry. These cycles of restructuring have predominantly occurred around merger and acquisition in the stock market. In these processes of restructuring, labour has been treated as a variable cost and managers have often sought to reduce the costs associated with labour by changing the conditions of work or reducing numbers employed. Unlike employees in other parts of Europe, British workers have had little support from the state in resisting these processes of change. As, therefore, trade union organization has declined in efficacy and impact, the power of managers urged on by shareholders to maximize shareholder value has increased. There has been no golden age when British employees were consulted and informed, had their jobs protected by labour market regulations and their skills enhanced by employers keen to invest in human capital.

From this perspective, the rise of private equity illustrates a change in the circumstances of financial capital as the perceived cost of the public corporation (in terms of agency costs, monitoring costs, regulatory and compliance costs) increased. Alongside this the ability to raise large funds enabling firms to be taken private and reorganized outside of the glare of competing interests and media publicity became increasingly attractive. There is no reason to believe that this change made much impact on how employees were managed. This continued much as before with some examples of high commitment work organization but many other examples of low skilled workers being squeezed to do more for less. The impetus for the change was primarily financial and as such it was supported by the well developed alliance of City institutions, the Treasury and the Bank of England. In a few short years, this model extended rapidly through the UK economy.

Gradually opposition to this grew on a range of grounds – from the treatment of employees through to the issues of taxation and systemic instability. For a brief period in 2007, this opposition appeared to be winning the public battle, a process which culminated in the grilling received by the industry association, the BVCA, and some of the top industry managers, by the House of Common Treasury Committee. However, this proved to be a false dawn as the Committee failed to produce any substantive proposals for change. The only change which came about was in terms of some minor increases in transparency, a change which was in fact engineered by the industry.

However if private equity lost the public battles but won the war, it was a pyrrhic victory as the crash of the financial system in 2008-2009 has completely changed the circumstances for the industry. The loss of liquidity, the flight to safety of investors, the collapse of the IPO and other markets for PE owned companies not only threatens to reduce the earnings from these investments but to actually cause the bankruptcy of these companies. It is not clear how long PE owned companies can continue to survive and pay the interest on their leveraged loans even where existing covenants have been renegotiated. The PE firms themselves are in precarious positions financially and many may yet go out of business as has happened to hedge funds. In many European countries, this will probably be the death-knell of private equity. In the UK, one would need to be slightly more cautious as whatever the route out of the current crisis and however strongly involved the state becomes in this, it is clear that the City will not easily give up its dominance within the UK context. Private equity may not return in the same way but other forms of financial engineering aimed at extracting value from the UK economy will no doubt arise again.

As soon as financial conditions changed and speculation, debt and leverage were exposed as high risk, private equity was left high and dry. It cannot borrow in the way it used to; nor can it exit its current investments. It is in effect left with the job of managing them profitably as far as it can in the hope that eventually market conditions will return that will allow it to exit and restructure its own assets. In the meantime this will be a testing time for the management abilities of private equity. Given previous experience, there is little reason to believe that they will adapt any better to the changed market conditions than any other form of corporate structure.

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