Private equity and public problems in a financialized world: an interview with Rosemary Batt

Rosemary Batt and Jamie Morgan [Cornell University, NY, USA; Leeds Beckett University Business School, UK]

Rosemary Batt is the Alice Hanson Cook Professor of Women and Work, Human Resource Studies and International Comparative Labor, in the Industrial and Labor Relations School, Cornell University. Whilst her work over the last thirty years has covered many aspects of employment relations, she is particularly well-known for her work on the role and consequences of Private Equity Finance undertaken in collaboration with Eileen Appelbaum, Co-Director of the Center for Economic and Policy Research (CEPR), Washington DC.[1] Private equity is a niche research subject for finance economists, and relatively few scholars in business, management, and labor relations have taken an interest in it. This is surprising as private equity has huge resources at its disposal and accounts for a significant proportion of annual merger and acquisition activity. It is a major employer and has exerted global influence on financial practices, society, business, and the economy.

Professor Batt is one of the few scholars to question the basic practices of private equity, notably its dependence on high levels of debt and financial engineering. Much of the work done on private equity in business and management schools restricts itself to econometric tests of fund performance and the application of standard finance and economic concepts (e.g. Jenkinson et al, 2016; Gompers et al, 2016; Davis et al, 2014; Axelson et al, 2013). This work tends to start from the perspective of an investor – and thus often restricts its focus to private equity as an "asset class" – rather than examining its effects on "Main Street" companies and their workers. Though some economists have recently become skeptical about private equity's claims regarding performance benefits, their research lacks a broader critical context and typically sits comfortably with private equity's own narrative that it seeks out hidden value and helps to turnaround failing firms (e.g. Gilligan and Wright, 2014; Kaplan et al, 2011).

Appelbaum and Batt's monograph *Private Equity at Work* (2014) and their many papers and presentations challenge this conventional view and broadens the examination of private equity to consider its effects on all stakeholders – including companies, managers, workers, suppliers, consumers, creditors, and communities (e.g. Appelbaum and Batt, 2019a, 2016, 2014; Appelbaum, Batt, and Clark, 2013; Batt and Appelbaum, 2020a, 2020b). Their work provides a much needed perspective that recently has been recognized – from the Institute for New Economic Thinking (INET) (Appelbaum and Batt, 2019b, 2020) to the *Financial Times* (Ford, 2019) and *The American Prospect*.[2]

Professor Batt studied at Cornell University graduating B.A. in history 1973; she received an M.A. in anthropology from University of Kentucky, 1981, and was awarded a PhD from Sloan School of Management, MIT in 1996. She has worked at Cornell since 1995.

[1] https://cepr.net/staff-member/eileen-appelbaum/.
[2] A reiteration of 2019b: https://prospect.org/power/private-equity-tries-protect-another-profit-center/.

Her work can be accessed at: https://www.ilr.cornell.edu/people/rosemary-batt

She is interviewed by Jamie Morgan for *RWER*...

Jamie: Given that many readers of *RWER* will have only a vague idea of what private equity is and what it does, perhaps you could begin by briefly introducing the concept and practice?

Rose: Thank you Jamie. First, let me say that this is an opportune time to talk about private equity (PE) firms and how they work because they play an increasingly important role in our economies and often have a detrimental effect on Main Street companies and their employees, vendors, and other stakeholders.

During the current pandemic crisis, they are already responsible for the financial distress and bankruptcy of many companies because their business model starts by loading these companies with excessive debt. In the meantime, private equity firms have had their best fundraising years ever and are sitting on billions of dollars in unused capital, which they plan to deploy post-pandemic to buy up, on the cheap, the assets of companies that fall into bankruptcy.

People need to take private equity and other private market actors seriously. The message was brought home in a scathing *Bloomberg* special report issued just before the pandemic, documenting the penetration of private equity into everyday life. It shocked even me – as the article listed brand after brand of companies that are household names, owned by PE; and it exposed the negative effects of their excessive use of debt and financial engineering to create billions for themselves and inequality for everyone else (Bloomberg, 2019).

So let me start with some background on how private equity works, and then I'll explain why their business model tends to have negative effects on Main Street businesses and their managers and workers.

Jamie: And to be clear, though you use the term "Main Street", which will be familiar to American readers, PE is a global practice. It emerged in the U.S. in the 1980s, but it operates all over the world, using a similar business model?

Rose: That's right. It has been a powerful and growing force in Europe at least since 2000, and more recently, in Asia and Latin America.

Private equity firms raise investment funds primarily from institutional investors – pension funds, endowments, insurance companies – as well as wealthy individuals. These investors, known as "limited partners" (LPs) account for about 98 percent of the capital in the fund, while the private equity partners, who manage the fund (the "General Partners" or GPs) put in the other 2 percent. The PE partners promise their investors "outsized returns" – that is, returns substantially above the stock market. Notably, in the U.S., roughly one-third of the investors are pension funds seeking to make sure they can cover pension payouts to their retirees in the coming years – and whilst this varies in other countries, institutional investors in general are now typically major investors in PE.

Jamie: And, again, just to be clear, the "fund" is a separate legal entity from the originating PE firm?

Rose: Yes, and in exchange for the promised higher returns, the LP investors sign a legal contract (the Limited Partner Agreement, or LPA) to commit their money to the fund for 10 years. So it is an "illiquid investment" – unlike investments in the stock market, where money can be shifted in response to market fluctuations. The Limited Partners also agree to pay an annual 2 percent management fee to the General Partners and to turn over all decision making power to them.[3] The GPs decide where and when to invest the money, and how and when to exit the investment.

The overwhelming majority of PE funds – over 80 percent – are used to buy out companies, take them private (off the public stock exchanges) or in other cases buy companies already privately owned. The aim is to resell them in a 3-5 year window.[4] The key to making outsized returns in this business model is the high use of debt to buy out the company – *debt that is loaded on the company itself* – not the PE firm. This strategy is referred to as a "leveraged buyout," or LBO.

Jamie: Just so readers are clear on why all this is important, perhaps you might briefly lay out the scale we are talking about here.

Rose: Sure. Private equity has become a powerful player in the global economy, but especially in the U.S. and Europe. I looked up the recent numbers. Between 2004 and 2019, it grew from $1 trillion in assets under management to $4.5 trillion – a compound annual growth rate of 10.8 percent – according to data collected by industry analysts such as Preqin, Bain, and PitchBook. Moreover, private equity fundraising in 2019 reached an historic high – $489.9 billion in some 440 funds – higher than the peak in the 2007 bubble year. North American PE firms raised about two-thirds of this total, while European firms raised roughly 20 percent (PitchBook, 2020). While fundraising has naturally fallen in 2020 due to the Covid-19 pandemic, institutional investors, including pension funds, say they are more committed than ever to investing in private equity.

Most of the world's largest private equity firms are located in the U.S. – 21 of the top 25 – with the remaining four headquartered in Europe. But the U.S. firms have a global reach – with buyouts in Europe and all over the world. By far the largest PE firm is Blackstone, with about $95 billion raised in the last five years; followed by Carlyle ($62B), Kohlberg, Kravis, and Roberts ($55B); and TPG, Warburg Pincus, Neuberger Berman, and CVC Capital Partners all at about $36B raised in that period (New Capital Management, 2020). These firms hold huge pools of private capital that they can deploy anywhere with few or any regulatory constraints and little or no transparency in their transactions.

Jamie: So, over time they have become major owners of companies and thus major employers – owning a string of familiar names in many countries… (see Bain & Company, 2019; Hammoud et al, 2017). But, if we focus on how all this is done and what that means, as your joint work with Eileen Appelbaum makes clear, the fund that now "owns" the company (the industry term is "acquisition" or "portfolio company") has *limited liability* – it only stands to

[3] Note from Jamie: As Rose goes on to establish in several different ways, PE general partners can make lucrative profits from the *fund management fees alone* – particularly as funds continue to expand in size with each round of fundraising. A 2% management fee continues to be the norm, with some discounts for large institutional investors. At 2% per year over ten years, GPs may reap up to 20% of the committed capital, regardless of whether the fund performs well or not.

[4] Note from Jamie: the industry term for this is "public to private"; there are various terms for other kinds of investment.

lose the "capital" supplied from the fund (otherwise known as its "equity" investment). This is very important to the incentive structure of PE?

Rose: Exactly. They buy out companies using other people's money, with very little of their own capital at risk. Using a lot of debt increases the relative returns on the equity they have invested – allowing the PE fund to multiply returns – and also spread the investment fund across a wider set of other buyouts, thereby diversifying its risk. The typical buyout uses about 65-70 percent debt (loans from banks and other creditors) and 30 percent equity from the PE fund. The GPs' own money represents only 2 percent of the total PE fund; so for any one buyout, their money at risk is only 0.6 percent of the total enterprise cost (.30 equity investment *.02 GP contribution = 0.6 percent). In other words, they have very little "skin in the game" – giving them incentives to take risks with other people's money. They gain on the upside with very little downside risk. Economists refer to this behavior as "moral hazard".

Jamie: So, in acquiring a company the GP replaces a significant percentage of the original value of the company's equity with debt, which leaves a smaller amount of equity supplied from the fund. Once this smaller amount of equity is returned to the fund, everything on top of that is potential profit to the fund (the basis of the "return" to investors). In the meantime, the acquired or "portfolio" company carries the debt partly used to buy it and has new higher debt servicing obligations? This seems to create a whole set of new risks for the company when PE takes over.

Rose: Many more risks than the public is probably aware of. The debt loaded on the company is the starting point for putting the company and workers at risk. It requires the company to cut costs and manage for cash to pay the interest on the debt or pay down the debt itself ("debt servicing"). After the buyout, the GPs typically assume positions on the company's board of directors, and essentially, direct the business and operations strategy. While the private equity GPs do look for opportunities to improve operations – particularly in smaller companies where there are clear opportunities to do so – the majority of private equity capital goes into large buyouts where there are few opportunities for "low-hanging fruit" – that is, relatively easy problems to be fixed. Large companies, for example, already have sophisticated accounting or HR systems; so then the focus turns to immediate cost cutting or other financial strategies. They reduce staffing levels or wages and benefits as needed; outsource or offshore work; or identify less profitable units to be closed – even if they still make a profit – rather than investing in and upgrading them. PE firms argue that this makes companies more efficient – "leaner".

Jamie: Cost cutting motivated by debt servicing pressures seems a weird concept of efficiency, very different than concentrating mainly on investment in innovation for productivity improvements and organic growth.

Rose: You're right, as you've shown in your own research on private equity. And we both know you can only squeeze so much juice out of an apple before you reach the core. In addition, the high debt load is only the first of many ways that private equity firms *extract* money from companies rather than investing and creating value. For example, PE firms typically require portfolio companies to sign a "Master Services Agreement" (MSA) in which the company pays the PE firm for "transactions fees" as well as "monitoring fees." A 2018 global survey of 213 PE fund managers found that 85 percent charged annual transactions fees in the range of 2-3 percent during the 2013-2018 period; and 58 percent charged monitoring fees in the range of 3-5 percent annually (PitchBook, 2018).

Yet, these agreements are fraught with conflicts of interest. PE firms own the company, sit on the board, and approve fees that benefit themselves. Monitoring agreements often do not specify what services actually will be provided (Polsky, 2014); and some require automatic renewals – referred to as "evergreen" agreements. Here, the automatic renewal may continue even *after* the PE firm exits from or sells the company, in which case the company must pay whatever millions in annual fees that are left. Ludovic Phalippou from Oxford University and colleagues exposed these and other practices in a brilliant article based on reviewing almost 600 leveraged buyouts with a value of $1.1 trillion. PE firms extracted $20 billion in fees from these companies. The article also sets out the content of specific MSA clauses to show the various ways that PE firms extract fees that represent pure value extraction unrelated to fund performance (Phalippou, Rauch, and Umber, 2018).

Jamie: A standard economic textbook might describe this as some form of market distorting behavior based on market structure (maybe involving "moral hazard" as you have already noted), but it seems more straightforward to call it opportunistic behavior based on power – and mainstream economics has always been quite poor at making sense of that.

Rose: Yes, and mainstream economics rarely incorporates the concept of asymmetric power into its analyses. Portfolio company fee extraction is just flagrant self-dealing.

Jamie: And this all can be done through a holding company that sits at the top of the new corporate structure of the acquisition and between the many other new and old entities of the acquisition and the fund(s)? For example, when KKR and Stefano Pessina bought Alliance Boots, ownership was restructured through AB holdings.

Rose: A holding company is a legal structure that may or may not apply in the particular case. The key interface is often the "platform" that PE funds set up to use to acquire companies. The main point is that the PE fund owns the company. It is the sole shareholder representing the interests of its investors; and through that financial control, appoints PE general partners to sit on the board of directors and hires the CEO and other top management officials. If the CEO does not carry out the strategic direction of the board, typically dominated by GPs and their appointees, then the board can fire the CEO. One study showed that 39 percent of CEOs were fired in the first 100 days of PE ownership and more than two-thirds at some point during the deal (Acharya, Hahn, and Kehoe 2009).

Let me also add that private equity funds also hold asymmetric power vis-à-vis the limited partners, which disadvantages the LPs in several ways. One relates to the Master Services Agreements, which are signed between the PE *firm* and the portfolio company – so the fees go straight to the PE firm, and the LPs often have no knowledge of what the fees include. The PE firms are supposed to share these fees with the Limited Partners, but the PE firms control all the financial accounting for services rendered (or not) and transactions completed (and under what conditions). In 2014, the U.S. Securities and Exchange Commission (SEC) found that about 50 percent of the PE firms it audited had not shared these fees with their Limited Partner investors (Bowden, 2014). Several PE firms reported that they did start sharing these fees with the LPs (now that they were caught), but we don't know if this is true due to the complete lack of transparency in PE transactions. The LPs also lose out because the fees reduce the value of the portfolio company so that it is likely to sell for less upon exit, lowering returns to the LP investors (Appelbaum and Batt, 2016).

Jamie: This and your previous comments raise a whole set of issues regarding the nature of law, regulation, and compliance – whether justice, fairness, or transparency and accountability are really to the fore in corporate dealings and whose interests are served – PE GPs, LPs, other investors, the public… I expect the real state of affairs is quite different than an ordinary member of the public might hope or expect from their legal *system*. But, to draw out the implications of the PE firm and its GP's incentive structure for the portfolio company (the "acquisition") …. Whatever else is involved, this structure is heavily focused on returning the equity used from the fund *to the fund,* as it is this that covers the fund against losses and eventually triggers "performance fees". The acquired company is a means to this end?

Rose: Yes. And PE firms use many other financial "tools" – what we refer to as "financial engineering" – to achieve their promised returns, even before they exit or sell the company. It is a lot easier and quicker to extract money through these financial tricks than through investing in companies to help them grow or compete effectively in today's competitive markets.

Jamie: And to clarify the context, as the GP is looking to exit the investment within 3-5 years, there is little incentive, as you have already suggested, to engage in uncertain long-term investment with no immediate payoff. By contrast, there are many reasons to focus on shorter term cost reductions, as this frees up cash for current debt servicing (and in an economic theory sense this can still look like an efficiency *gain* even though it may be to the long term detriment of the business). What kind of "tools" are we talking about?

Rose: Among the most brazen tactics is the use of "dividend recapitalizations" – in which the PE firm uses company collateral to take out additional debt, load it on the company, and then use it to pay out dividends to themselves and their investors. Because the company already carries a high debt load, the new loans are rated low or "junk bond" status and carry a higher interest rate, further burdening the company's balance sheet. Another purely value extracting tactic is to divide a company into two parts – a property company and an operating company – and sell off the property, which is then used for investor dividends. The company then must pay inflated rent on property it once owned, which severely reduces net revenues. This tactic is widely used in retail because stores traditionally have owned their own property in order to weather downturns in the economy – so the property is a cash cow. A more recent version of this strategy is to separate the intellectual property of a company – for example the brand – from the operations. The PE firm holds onto the valuable brand but loads all the debt onto the operating company and lets it go bankrupt. This is behind the recent bankruptcy of J. Crew, but I'll come to that when we discuss the Covid-19 pandemic situation in more detail.

Jamie: So the combined significance of these activities is…

Rose: Well, several fold. First, the activities undermine the financial stability of companies, making them more vulnerable to financial distress or bankruptcy. High debt loads – often in the millions of dollars in companies that never accumulated debt in the past – are deadly for companies at any time, but especially in an economic downturn like the Great Recession of 2008 and the current pandemic. And the spillover effects ripple through companies – throwing managers and workers on the streets, leaving venders and suppliers with unpaid bills, and creditors often taking a haircut.

Jamie: Because massively increased debt means that more of the available revenue is needed for debt servicing and so it takes a smaller fall in revenues for the acquisition to become loss making or to be unable to service debt – thus triggering bank covenants on its debt or pushing the acquisition into insolvency or bankruptcy. A small downturn can have a big effect and a recession or crisis can be devastating…

Rose: But note, these financial engineering tactics plus the fees extracted from companies often mean that the PE general partners and their investors have extracted enough value to pay themselves back and more in the first two or three years of ownership – before they exit or sell the company. At that point, if the company fails, they can walk away, knowing that they have already made back their investment many times over.

Jamie: And "limited liability" protects both the GP and LPs?

Rose: It does, but there is a second point. Some of these tactics hurt the Limited Partners as well. Recall that the PE general partners seek to maximize profits at the level of *the PE firm itself – not for any particular portfolio company*. A PE firm can operate several funds and has little of its own money in any one of them, but the LPs have much more at stake in any one fund or investment. Financial engineering tactics – such as extracting fees from the portfolio company or selling the company's property and making it lease it back at inflated rates – cut into net revenues and in turn, cut into the sales value of the company and what it can command upon exit. This may lead to lower returns on exit, which hit the LPs much more than the PE partners. And if things go wrong, the PE firm walks away with minor losses compared to its overall gains at the level of the PE firm. Note that this can also mean any subsequent refinancing is at higher interest rates because the company now has fewer assets for collateralization and greater risk based on combined debt servicing. So, the vulnerability of the company can continue to evolve because of financial engineering.

Jamie: This raises a whole set of issues that economics has tended to obscure – not least the difference between wealth capture, wealth extraction, and wealth creation. Economics tends to assume the first leads to the last (investment, market discipline, and efficiency or failure) and often pays little attention to extraction. PE seems to, at least, blur the distinction between creation and extraction.

Rose: You make a very important point that needs more attention in academic and media outlets. Private equity firms argue that they create efficiency by buying and selling company assets – as if they were commodities or Lego pieces – subjecting them to the price competition of the market and thereby disciplining management to be efficient. They might call on Schumpeter to defend themselves, arguing that they create value through destruction. By selling off or destroying less productive assets, they free up capital to buy (create) higher performing ones.

But the best empirical evidence doesn't support that storyline. One of the most sophisticated and widely accepted studies of private equity and productivity by highly respected U.S. economists compared pre- and post-conditions of private equity buyouts to comparable publicly traded ones during a five year period (Davis et al, 2014). They found that PE target companies paid higher wages and had higher employment levels *pre-buyout* than did their publicly traded counterparts. *Post-buyout*, however, wages had fallen and employment growth was lower in the PE owned companies. The PE funds had targeted companies with better fundamentals and "increased productivity" by lowering labor costs – reducing the denominator in the productivity ratio and shifting capital from labor to themselves. Moreover, they went on to show that PE firms closed the employment deficit in their companies compared to the publicly traded ones (to about 1-2 percent) by buying (acquiring) new establishments. So this reinforces the point made earlier, they counted the newly "purchased employees" as if they were equal to hiring new employees for "organic growth".

Jamie: So, what you are suggesting is that although PE activity can superficially look like it is creating "value", this is problematic. Its real effects involve transfers from what might otherwise have gone to employees ("labor") to owners ("capital"). At the same time, some of the changes made tend to conceal how "productivity" is created (less by investment and more by rationalization – a simple mathematical effect). Similarly, PE firms claim to create jobs, but in fact they may simply be aggregating the jobs from other entities they bought – not what a layperson might think of as a vibrant growing business? The two seem to also imply problems for the quality of employment. And, of course, the general implication is that the "value created" for fund investors (a standard terminology in the PE sector) does not necessarily come from value *created* in the portfolio company (hence a problem of wealth capture and wealth extraction). All of this raises a more fundamental question about whether we (as societies) should *value* what PE does – though that shifts what we mean by "value".

Rose: We can come back to this, but the important point is that shifting a greater share of productivity gains to capital or buying other companies to enlarge your own – hardly constitute "creative destruction" that contributes to overall productivity or economic growth. It's just robbing Peter to pay Paul.

Jamie: PE tends to market itself on the basis of finding "hidden value" and on turning around failing companies, so this seems to question that whole narrative (that PE is good for companies, good for markets, and good for the economy). Earlier, you mentioned that the problems PE creates are particularly evident in economic downturns like the Great Recession. Is there empirical evidence? Do you have specific examples?

Rose: Absolutely. In our 2014 book, we did a deep dive into the patterns of financial distress and bankruptcy related to the 2008 recession (Chapter 4). Highly leveraged companies had much higher rates of bankruptcy during and after the 2008 recession than did comparable companies without these high levels. And PE owned companies were disproportionately among those companies with elevated debt levels. The stories from the retail sector are particularly noteworthy. PE likes retail because it "throws off a lot of cash" and has property assets to sell – allowing PE to extract wealth while owning the company and exit in a few years.

Jamie: So, retail (with property, cash flow, and a customer base) is a sector particularly suited to collateralizing debt, used to buy a company through an LBO and to meeting debt servicing obligations. So, retail is a preferred target for large scale PE activity…

Rose: We wrote about the classic PE retail playbook in our book. Mervyns' Department Store was an iconic regional chain in California with a strong reputation for good value and positive community relations through its foundation. PE firm, Sun Capital, bought the chain from Target in 2004 in a leveraged buyout for $1.2 billion (with one-third equity, leaving $800 million in debt). Sun immediately sold off the real estate of the chain, paid itself back its $400 million in equity, and required Mervyns to lease property at inflated rates. It then loaded the company with more debt to pay itself and its investors a dividend. It closed some lower performing stores, required a 15 percent across the board headcount, ended the foundation, cut staff in warehouses, and refused to honor a credit arrangement that made it possible for vendors to get advance payment to supply seasonal merchandise. The stores soon looked shabby, lacked cleanliness, and the chain declared bankruptcy when the 2008 financial crisis hit. In fact, Mervyns' revenues were in the black that year – at $64 million – but it owed $80 million in rent on the property it used to own. 30,000 workers lost their jobs, while private equity investors walked away with millions in four years. The UK's beloved Debenhams Department Store had a similar fatal dance with private equity in the 2000s that has had lasting effects.

Jamie: Yes, though the effects are not necessarily bankruptcy, but they can still cause ongoing problems because of debt legacies (the worst does not have to happen for the practice to have been problematic). This raises an important point. Portfolio companies retain their trading names when PE firms acquire them, so the public attributes any negative outcomes to the company rather than the PE firm, which is a guiding influence behind the scenes. This tends to obscure the role PE firms play collectively and serially in the problems that sectors and economies suffer. And the problems PE creates – underinvestment, rationalization, debt legacies and so forth – can continue long after PE exits the company.

Rose: Yes, and the retail sector is a good example. The press now attributes retail problems and bankruptcies to the "retail apocalypse" and e-commerce. And of course, technological disruption and monopoly players are biting into retail revenues and profit margins. But a disproportionate number of recent retail bankruptcies have been driven by private equity – *not Tesco, Walmart, or Amazon.* Between 2012 and 2019, for example, 10 of the 14 largest U.S. retail chain bankruptcies were PE owned chains; these led to the loss of 1.3 million jobs – 600,000 direct jobs in the sector and over 700,000 jobs in related businesses such as suppliers and distributors (Baker, Corser, and Vitulli, 2019). The most widely publicized was the 2017 bankruptcy of the beloved children's store, Toys R Us, burdened with $5 billion in debt from a PE leveraged buyout by Bain, KKR, and Vornado Realty. It threw 30,000 workers on the streets – as you set out in your article (Morgan and Nasir, 2020). But many more iconic brands fell beneath the weight of PE-levered debt and wealth extraction – including in the U.S., Barneys New York, Gymboree, Charlotte Russe, Sports Authority, 9 West, and Payless Shoe Source.

Private equity firms have also driven bankruptcies in the U.S. grocery store segment. Between 2015 and 2018, seven regional grocery store chains declared bankruptcy, and media accounts ascribed these to Walmart and Amazon. But, in fact, PE firms owned all seven. In the same timeframe, NO publicly traded grocery chains went bankrupt, even though they all faced the same degree of competition. Almost all of the bankruptcies were due to excessive debt from PE buyouts that the chains couldn't repay – coupled with PE's sell-off of their real estate so that net revenues went down. This left them with few reserves to invest in store upgrades, online shopping, labor saving technologies, or innovative product lines that would have let them stay current with changing consumer demands and tastes (Appelbaum and Batt, 2018).

Jamie: So, from this point of view, PE can be helping companies fail rather than turning around failing companies? This really brings us back to how PE's role is often obscured…

Rose: Yes, it is also important that the names of most private equity firms are not well known or known at all. And recall that in the U.S. and UK, at least, all of this behavior is perfectly legal. And most people – including union leaders, institutional investors themselves, politicians, consumers, the public generally – are not financially sophisticated enough, nor do they pay attention to the financial weeds buried in the *Wall Street Journal*. It's easy to accept the prevailing accounts that financial problems are just due to economic downturns, new technology, the "retail apocalypse," or overly demanding unions (despite the massive loss in union power in recent decades).

Jamie: Though every now and then PE firms do come into focus – "Barbarians at the Gate" and so on…

Rose: But most of the time they operate in "the shadows" and have little or no transparency – even in their meager reporting requirements to the SEC in the U.S. They are the "puppeteers behind the puppets," – according to a long time labor activist from the Service Employees International Union (SEIU) – Jono Schaeffer. The private equity firm that owns Friendly's Ice Cream and drives it into bankruptcy does not get the blame – people just assume it must be Friendly's "bad management". End of story.

Jamie: Your work over the years with Eileen Appelbaum then has been very important in shedding light on the Main Street problems caused by Wall Street that economics has mainly failed to address. But a term like "Main Street" tends to bring to mind the kind of examples we have used so far – those that people understand as typically "commercial" businesses in private sector markets. But hasn't private equity penetrated public services in the same way? Services that are vital to social welfare? Given the growth of public-private partnerships and outright privatization of public services, hasn't private equity played a role here that is also, from a public prominence point of view, behind the scenes?

Rose: I wish I could say no. Eileen and I have followed private equity's penetration into the U.S. healthcare industry for several years, and the results are very disturbing. The early example is nursing homes, where PE investments accelerated in the 2000s due in part to the fact that government funding secures a steady flow of cash. Large PE-owned chains included ManorCare, Beverly, and Mariner Health Care, which the SEIU featured in a major exposé of the PE nursing home model (2007). The PE model was to first sell off the property underneath the homes for an immediate dividend to PE and its investors; second, to break up the chain and make each physical location a separate legal entity so that even if sued by patients, there were no assets to go after; and third, to cut operating costs, particularly labor. Several U.S. studies provide empirical evidence that the result of PE ownership is lower staffing levels (Pradhan et al, 2015) and lower care quality (Gupta et al, 2020). Studies of UK homes show similar results (Burns, Hyde, and Killett, 2016). The UK government has begun to wake up – with shocking audit reports, for example, of the second largest chain Four Seasons Health Care (owned by PE firm Terra Firma) – which found food deprivation, unsanitary conditions, the spread of infections, and more (De Freytas-Tamura, 2018). And a recent investigative report of New Jersey Homes in the U.S. found that PE owned homes had 25 percent higher Covid-19 infection rates than the statewide average and 10.2 percent higher fatalities (AFR, 2020b).

Jamie: Given all the other features of the business model, PE seems particularly problematic when its business model is applied to key public services and matters of basic human welfare. There can be something brutal in the way private equity treats its acquisitions as assets in a portfolio for the purposes of returns to its funds and the PE firm – LPs and GPs. And yet, apart from your work and a few others, this has received little attention, perhaps partly because PE benefits from a more general preference for the private sector.[5] The general trend in many countries has been to seek to apply private sector decision making in service and welfare contexts, on the assumption that this leads to efficiency, and efficiency leads to better services and better value for money. It seems likely that there is a general assumption that PE fits this way of thinking, paralleling new public management theory etc.

Rose: Efficient for whom and at what human cost? There are many examples beyond nursing homes. Our cumulative research on private equity activity in healthcare shows that PE investments in the sector have dramatically escalated since the 2008 recession (Appelbaum and Batt, 2020). PE investments in the U.S. healthcare sector grew from less than $5 billion annually in 2000 to $100 billion in 2018 – a 20-fold increase. PE serves as a market aggregator and reseller, using a well-developed "buy and build" strategy in which it establishes a "platform" by buying out one enterprise and then adding on and rolling up a series of similar enterprises. The strategy allows PE firms to operate below the radar of anti-trust regulators because any one acquisition is too small to fall under their jurisdiction, but overall the strategy helps PE achieve economies of scale and market power at the local, regional, or national level.

Using this strategy, private equity firms started buying up specialist physician practices (anesthesiologists, radiologists, etc.) to form national staffing firms for hospital emergency rooms (ER). They took advantage of a trend among hospitals to outsource ER services to cut costs. Two PE firms now control 30 percent of this large market and are behind a recent phenomenon known as "surprise medical billing". This practice takes advantage of the fact that U.S. insurance companies negotiate with hospitals to cover patients admitted to those hospitals. But because the outsourced ER services are not covered by that contract, the physician staffing firm can charge "out of network" rates – essentially anything they want because they are not constrained by the payers or the government. As a result, thousands of patients have been hit with thousands of dollars in "surprise medical bills" that they thought their insurance company was covering. PE firms also own 2 of the 3 largest national air ambulance companies that are among the worst offenders of surprise medical bills. And despite the public and media outcry, the U.S. Congress has yet to pass a bill to curb this shocking behavior (Appelbaum and Batt, 2019b, 2019c).

Jamie: Again, these practices seem to have little to do with improving efficiency – if by that we mean quality of service and pricing – and far more to do with exploiting opportunity. Whilst this might be irritating in what we traditionally mean by the commercial sector, it seems much more serious in social and healthcare contexts – perhaps deadly serious. And this brings us conveniently to a subject I know you are keen to discuss – the way PE has and seems likely to respond to the Covid-19 pandemic. This begins with already existing vulnerabilities created in healthcare – problems of instability, insolvency etc. – which seem to parallel your retail apocalypse point, but extend beyond this?

Rose: Let me start with the issue of vulnerability. Private equity firms also have used the buy and build strategy, along with the sale of medical properties, to pay themselves dividends. They have created national hospital chains with excessive debt loads that are financially

[5] Note from Jamie: If interested in following up any of the issues, in addition to Appelbaum and Batt's work and the references given so far, see (Bedu and Montalban 2014; Clark 2009, 2011, 2013, 2016; De Cock and Nyberg, 2016; Erturk et al, 2010; Froud et al, 2012; Froud and Williams, 2007; Kosman, 2009; Morgan, 2009; Morrell and Clark, 2010; Phalippou, 2017; Rodrigues and Child, 2010; Scheuplein, 2019; Souleles, 2017, 2019).

unstable. Particularly egregious examples include Prospect Medical Holdings, owned by Leonard Green Partners, which has preyed on safety net hospitals and run them into bankruptcy (Elkind, 2020), and Steward Healthcare Systems, owned by Cerberus Capital (La France, Batt, and Appelbaum 2020). After converting six small Catholic community hospitals into a PE owned chain, Cerberus sold off the property and used the proceeds to pay themselves dividends and to buy up a series of hospitals around the country – again using the classic leveraged buyout model. Now laden with unsustainable debt, Steward is ranked the lowest of any Massachusetts chain in terms of financial stability, with a negative 38% finance equity ratio (an indicator of high debt). In the meantime, it had the audacity to demand bailouts under the government's Covid-19 relief program for one of its hospitals – under threat to the Governor of Pennsylvania that it would close the hospital if it did not get the money. It got the money! (Batt and Appelbaum, 2020a)

Jamie: So clearly, PE practices can undermine the ability of social and healthcare services to cope, just when you need them to have the spare capacity and flexibility to respond to crises? Early on in our interview, you suggested: "During the current pandemic crisis, they are already responsible for the financial distress and bankruptcy of many companies because their business model starts by loading these companies with excessive debt."

Rose: Let me elaborate. As we entered the Covid-19 era in early 2020, private equity owned companies were among the worst poised to face a crisis that is already the worst since the Great Depression of almost a century ago. In 2019, 14 PE owned companies defaulted. Between the end of 2018 and 2019, the number of private equity backed companies with credit ratings in distress (a total of 99), had grown by almost 30%. Distressed ratings are those with a B- rating or worse and have a negative financial outlook – a significant probability of defaulting on their bonds. This data probably understates the problem because it only included rated companies; non-rated PE owned companies are those that do not have to make their financials public (Rodriguez-Valladares, 2019). By April, 2020, Moody's Investors Service reported that in the first quarter of 2020, 56 percent of the 18 corporate family defaults were private equity owned companies (Rodriguez-Valladares, 2020a). In July, 2020, Moody's reported that rated company defaults were rising; and again, that PE-owned leveraged buyouts represented a disproportionate share – over half. It went on to report that the defaults for the rest of 2020 are likely to be from PE-owned companies because roughly 70% are financed only with leveraged loans and about the same share on Moody's B3N list are also PE-owned. By comparison, PE-owned companies represented 45 percent of those on the list at the height of the financial crisis (Rodriguez-Valladares, 2020b).

Jamie: It is also worth noting here, following your examples from retail and healthcare, that PE firms tend to have common foci: the characteristics of the companies they buy, the methods they use to buy them – and this can have collective consequences.[6] The Bank of England, for example, keeps a particular eye on leverage levels, use of covenant-lite practices, structured debt, bond issuance (bundling debt), and securitization (bundling bundles of debt or mirroring them with derivatives) in order to stress test likely causes of financial instability and crisis at a macroeconomic level.[7] Whilst the Bank does not suggest

[6] Note from Jamie: PE firms and lobbyists tend to argue that they operate in many different sectors; but this is not quite what we mean. There is also herding – fund solicitation follows fashions – within sectors it is debt servicing potential that often dominates and debt loading leads to collective effects on corporations in the sector and macroeconomic financial stability effects may follow.
[7] Note from Jamie: A covenant-lite loan has fewer restrictions and less monitoring from the loan issuer and is considered higher risk.

that PE is a sole or major cause of financial instability (such as the Global Financial Crisis), its analyses have shown that it can contribute to instability (see Gregory, 2013; Bank of England, 2019). Current attention, for example, is focused on the Commercial Mortgage Backed Securities (CMBS) market and Collateralized Debt Obligations or CDOs (as well as specific PE Collateralized Loan Obligations). The retail apocalypse – which as you have suggested PE has contributed to – is one facet of changes to urban and suburban commercial land use, and this has caused drops in valuation (exacerbated by Covid-19) in high streets, shopping malls, and office space. This affects the loans wrapped up in CMBS (increased delinquency, covenant breaches, distress and default) and these underpin a class of CDOs. Because these trade as financial assets, a further problem here is of risk diffusion becoming risk contagion: all problems indicative of a Minsky cycle or Kindleberger's manias and panics.

Rose: This all starts though with the PE business model, and each buyout and its consequences. In the current pandemic, PE-owned retail chains in the U.S. have been among the first to face financial distress and bankruptcy – including well-known U.S. brands like J. Crew, Nieman Marcus, and Sears. The numbers are stunning. Between 2010 and 2020, private equity funds had invested roughly $90 billion in U.S. retail, according to Dealogic, an industry research firm. Despite this huge investment, private equity represents only a small portion of the roughly 1 million retail establishments in the U.S. (National Retail Federation, 2020). Nonetheless, as of April, 2020, Moody's Investor Services reported that 27 out of 38 retailers with the weakest credit profiles – more than 70% – were owned by PE. These chains include sports-equipment seller Academy Sports & Outdoors, 99 Cents Only Stores LLC, and Guitar Center Inc. (Louch and Cooper, 2020).

Early in the interview, I mentioned J.Crew and said I would return to this example. The demise of J. Crew in April, 2020, under the ownership of TPG Capital and Leonard Green & Partners, illustrates a new level of cunning financial engineering that even creditors have balked at. The bankruptcy was well in the works before Covid-19 hit. The private equity duo bought the holding company that included J. Crew, Madewell, and Charlotte Russe for $3 billion in 2011 – using only $1.1 billion in equity and loading the company with the remaining $1.9 billion in debt. Despite promising to expand the company in the U.S. and internationally, they soon took $700 million out of the company – in the form of dividends and fees – allowing them to recoup in two short years, 70% of what they had invested ($680 million in dividends and $19 million in fees). This left little money for store upgrades or expansions. The PE firm then sold J. Crew's intellectual property, its valuable brand name, to a new subsidiary it created – located in the Cayman islands – so it would not be available to pay off creditors in case of financial distress. Then it split the company in two – with the most valuable part – Madewell brand – a separate legal entity, also out of reach of creditors. Finally, the PE firms left all the debt – about $1.65 billion – on J. Crew, leading to its recent bankruptcy and the potential loss of 13,000 workers' jobs (Appelbaum, Park, and Batt, 2020).

Jamie: And reference to the Cayman Islands highlights another important issue here. We talk about companies as though they were just one corporation; but they are typically a string of corporations, which collectively comprise its organization.[8] Like any other organization, PE has the option (and this may be more of an issue outside the U.S.) to structure its acquisition's incorporations for what it refers to as "tax efficiency", but which others might

[8] Note from Jamie: In economics, with a nod to Coase, this is sometimes termed the 'firm', but in legal discourse in the U.S. this refers to a partnership, so there can be some confusion. The key point is that the entity may be a collection of separated corporations, involving complex connections where one may own another etc. (perhaps as a 'Multinational Enterprise or MNE). Sol Picciotto makes this point.

label avoidance (an aggressive but legal means to radically reduce tax owed in any given jurisdiction). The organization creates a new corporation in a “tax secrecy” jurisdiction or “tax haven”. Sales, revenues, and profits can then be channeled there; and this combined with the use of strategically located debt can be used to reduce tax liabilities and offset any tax owed (for general issues, see Morgan 2016, 2020; Seabrooke and Wigan, 2020). But we digress, we were discussing financial distress and bankruptcy and how the pandemic might exacerbate that for PE portfolio companies. Do you have other examples?

Rose: There are many others. Nieman Marcus filed for bankruptcy in May, 2020, when it could no longer sustain the load of $5 billion in debt accrued through two rounds of leveraged buyouts and 15 years of private equity ownership. In the same period, the PE owners extracted roughly $500 million in dividends and fees alone (PESP, 2020a). And like TPG Capital and Leonard Green at J. Crew, they transferred valuable company assets – in this case, the luxury E-commerce retailer MyTheresa – to the PE owners and therefore out of reach of the bondholders, who have claimed this was an improper transfer that leaves little to protect the company’s unsecured debt (Maheshwari and Friedman, 2020).

And just so I don’t give the impression that nothing happens outside America, the bankruptcy of Debenhams – in April, 2019, and again in April, 2020 – is also attributed to the retail apocalypse and the company’s failure to upgrade its stores and merchandising – as well as the Covid-19 pandemic. But behind the financial struggles of UK’s 200 year historic department store is the invisible hand of private equity. A leveraged buyout in 2003 by U.S. PE firms Texas Pacific Group, CVC, and Merrill Lynch, saddled the company with £1.2bn in debt (in a buyout worth £1.8bn). After cutting costs for store improvements by 77 percent, selling off property, and negotiating long-term leases for property the company used to own, the PE consortium exited Debenhams in 2006 for £1.7bn after having extracted £1.3bn for themselves. The costly long-term leases continued to cut into net revenues and saddle the company’s efforts to restructure or close underperforming stores (Chapman, 2018). In April, 2020, almost 15 years after PE ownership, Debenhams was still carrying £600m in debt (Littlelaw, 2020).

Jamie: In talking about the pandemic, the other point you were keen to emphasize early on in the interview was that PE firms have had their best fundraising years ever and are sitting on billions of dollars in unused capital, which they plan to deploy post-pandemic to buy up, on the cheap, the assets of companies that fall into bankruptcy. Several different databases track PE and report metrics, and the consensus figure at the moment suggests that the major PE firms have (November 2020) between $2 and $2.5 trillion in “dry powder” (unused committed capital available from their funds).[9]

Rose: That’s right. In the bubble years before the great recession, PE funds “called” or invested 16.3 percent of committed capital in 2006 and 19.1 percent in 2007. In 2018, however, they called only 4.1 percent of funds, and in 2019, 3.3 percent (Segal, 2020). So, there is substantial accumulation of unused but committed capital from LPs, as well as ongoing solicitations for new funds. With this abundance of capital available, PE is poised to buy distressed assets at a bargain. Many companies or owners may be desperate, and there are many reasons why now is an opportune moment for PE buyouts.

[9] Note from Jamie: Sources differ (different databases can contain different PE and estimates are moving targets), but there is a trend increase and a significant scale: As of December, 2019, PE firms were sitting on over $2 trillion in ‘dry powder’ – $2.3 Trillion, according to PitchBook (2020) and $2.5 Trillion, according to Bain & Company (2020).

Jamie: The pandemic creates multiple opportunities seemingly. Let's consider a few. The most immediate effects are falling share prices, which mean that companies' market capitalization falls (the company becomes cheaper); this attracts activist investors like hedge funds, who may short the company or position one of their personnel on the Board and then push for divestments etc. This can play into the hands of PE firms, who pick up the divested part; or PE can come in as an alternative management solution (the classic language of competition for control associated with Michael Jensen) for the whole enterprise. In any case, shareholders may be more open to a takeover if dividends are not being paid, and if the future is uncertain and share prices are volatile or depressed. This takeover can be hostile or agreed; but in either case, new opportunities seem to be created for PE when corporate governance is unable or less likely to offer resistance. Cheaper targets and historic low interest rates for debt purposes seem likely to accelerate PE activity in the coming months. As surely, in the UK, will Brexit's effect on short term economic prospects. The FTSE 250, for example, was down almost 25% to November from February 2020 (and a falling exchange rate will also make UK registered firms cheaper to $ buyers).

Rose: PE firms are strategic as well as opportunistic. When the Covid-19 pandemic initially hit, the private equity firms substantially reduced their buyout activity and assessed the damage to their companies in industries hard hit by the Coronavirus. But by the summer, their deal making picked up, buoyed by the U.S. Federal Reserve, which established a corporate-bond buying program that added liquidity to the market and provided financial stability for the stock market. This also facilitated the return of the leveraged loan market (below-investment-grade), which funds many buyouts. Overall, private equity firms, flush with cash, are well-positioned to take advantage of the pandemic and buy up the best deals. According to Preqin's third quarter 2020 report, PE leveraged buyout funds alone had $1.6 trillion on hand, and the buyouts and debt-funded dividends had "taken off". KKR, for example, took a $560 million dividend from a tech company it owned, Epicor Software Corp., in a recapitalization that facilitated its sale (a month later) to PE firm Clayton Dubilier & Rice. Bloomberg reported that, "… competition among lenders to finance buyouts is so intense that private equity barons are getting financing on terms that are in line with or even better than those before the Covid-19 outbreak" (Scigliuzzo, Lee, and Seligson, 2020). PE titans are expressing optimism and confidence (BB&T|SunTrust now Truist, 2020).

Many PE firms are moving quickly into those sectors not affected or even benefitting from the Covid-19 crisis, such as high tech and healthcare (Gottfried, 2020). Other PE firms are looking to take advantage of distressed "assets" and buy them up cheaply.

A lesson from the last financial crisis is worrisome. Between 2013 and 2017 alone, private equity firms took advantage of the housing crisis and bought up hundreds of thousands of foreclosed single family homes, turned them into rental properties, and bundled and securitized them to create $19.2 billion in "single family rental bonds". The two largest PE housing companies, Starwood Waypoint and Blackstone's Invitation Homes, merged to form a combined portfolio of 82,000 properties – one of the largest landlords in the U.S. They concentrated their buying in certain local markets to create monopoly power (Atlanta, Los Angeles, Houston, Miami, and others), increased rents dramatically, charged excessive maintenance and late fees, and had higher eviction rates than "mom and pop" landlords, according to a Federal Reserve Bank Report (Abood, 2018). Institutional investors owned over 200,000 rental homes as of December, 2017, and the number has continued to grow. In the current pandemic, private equity landlords are already evicting tenants even though the

Trump Administration placed a moratorium on evictions until December 31, 2020 (PESP, 2020b).

Jamie: If this were higher profile it would surely cause PE "reputational damage".

Rose: And, private equity's preying on poor and marginalized groups doesn't stop there. Post financial crisis, they swept into the payday lending market, and as of 2017, owned over 5,000 store front locations that often make loans at over $300 percent annual interest rates – some up to $600 percent – often illegal rates above state maximums.[10] Consumer credit for people who have no other alternative, these operations offer short-term loans with "friendly" "roll overs"; and several PE-owned lenders have been sued by states for deceptive and intimidating practices that have left borrowers in a long-term cycle of debt (PESP, 2017; AFR, 2020a).

Another marginalized group subject to private equity abuse are the incarcerated and their families. It may come as a shock to Europeans, but the U.S. prison industry – the largest in the world – is substantially privatized through the contracting out of prison services to private vendors. And the largest players in that market? PE firms, of course. These own commissary, telecommunications, and healthcare services companies and use monopoly power to charge excessive fees for often poor quality food and services that families of the incarcerated must pay (PESP, 2019a, 2019b, 2019c). During the pandemic, when Covid-19 cases have skyrocketed in prisons, the only communication between the incarcerated and their families was via communications systems largely owned by PE firms charging outrageous fees.

Jamie: Covid-19 is a very odd kind of economic crisis. In the UK and many EU countries, Australia etc., for example, lockdowns are essentially an orchestrated suppression of economic activity (tourism, hospitality, face to face retail), rather than inadvertent recession – though the U.S. and some other places have done less "locking down". In any case, the pandemic brings otherwise viable companies to a halt (either directly by lockdowns or indirectly by radical changes to social behavior). PE seemingly may be a beneficiary, but your work also suggests that investors (Limited Partners) may *not* benefit as much as they think and you have already alluded to this, but there seems more to say.

Rose: Well, given the financial tactics that private equity firms use, you would think that their funds would indeed beat the stock market by a lot and that the LPs would benefit. But the empirical evidence from finance economists on this point is the opposite. The median, or typical private equity fund has not beaten the S&P 500 since 2006. As summarized in our review of the empirical evidence (Appelbaum and Batt, 2019a), recent studies do find that the top quartile funds still beat the S&P 500 by a reasonable margin – but *not* the median fund launched in 2006 or later (Harris, Jenkinson, and Kaplan, 2015; L'Her, Stoyanova, Shaw, Scott, and Lai, 2016; PitchBook, 2016; Phalippou, 2020). The 2016 PitchBook analysis used the Russell 3000 index as the metric of comparison, and found that by 2006, the typical fund roughly matched the Russell 3000.

[10] Note from Rose: That is, they make a loan with an interest rate of perhaps 25 or 30% per month, and then it rolls over because the borrower can't pay, with the end result of an interest rate that is $300+ or more.

Equally important, research shows that there is no longer "persistence" in fund performance – meaning that an initial fund that performs well does not predict the performance of a follow on fund by the same general partner in the same private equity firm (White, 2017). A recent paper by mainstream economists published by the National Bureau of Economic Research (NBER) has again demonstrated this fact (Harris, Jenkinson, Kaplan, and Stucke, 2020).

Jamie: How might you explain this?

Rose: Poor fund performance is probably due to more competition for "good" target companies needed to bring strong returns. Competition has increased substantially in the last decade or so because of the rapid growth in the number of PE firms – the "dry powder" mentioned previously.[11] The competitive landscape also includes major publicly traded corporations with trillions in cash on hand. The result is that the price of buyout targets in 2019 averaged more than 11X the enterprise value in the U.S., or EBIDTA (Earnings Before Interest, Depreciation, Taxes, and Amortization) – higher than even the bubble years of 2006-2007. It was over 10X EBITDA in the UK (Bain & Company, 2020). Arguably, this confluence of factors has led to poor and falling PE fund returns. And, of course, all the things we have discussed about fees charged to LPs are relevant here. The pandemic may depress share valuations but not necessarily enough for this to matter in the long term against the trend of bull markets.

Note also, however, that PE firms have continued to make money for themselves despite the poor performance of their funds, because they continue to get management fees from the LPs and monitoring fees from the portfolio companies, regardless of how the fund performs. Limited Partners, including pension funds, are paying extraordinarily high fees for mediocre PE fund performance. Recall that they pay an annual 2 percent management fee to the PE firm, with no strings attached and no accountability. Assuming a 10-year commitment, that means that LP fees paid to the PE firm equal 20 percent of the entire investment fund. While some argue that the PE firms have reduced fees to about 1.5 percent, the evidence is thin: they have reduced fees for some of the largest LPs with long term relations – that's about it.

Jamie: And then there is "carried interest".

Rose: Yes, this is supposed to be a "performance fee", and we briefly mentioned that earlier. PE firms take 20 percent of the returns. Phalippou's recent research paper on this point ("An Inconvenient Fact…") is particularly compelling, as he also shows that despite PE fund performance that roughly matches public indices, the big four PE firms collected an estimated $230 billion in performance fees. Pension funds would have been better off investing in a simple index fund, such as Vanguard. The number of PE billionaires was 3 in 2005 but 22 in 2020 (Phalippou, 2020).

Jamie: But the fees issue raises a more general concern. Given that many PE institutional investors are pension funds, there seems a major contradiction here. Pension funds represent workers, and their capital is comprised of contributions by workers; but they are investing in PE funds that often damage companies and thus wages, incomes, unionization, terms and conditions, and livelihoods. And if they are doing this in order to secure high returns to finance

[11] Note from Rose: LPs have to keep that capital in an escrow account for the GPs and cannot use it to invest anywhere else. Between 2007 and 2017, for example, the number of investors in private equity increased by 51 percent (Pitchbook, 2018).

pensions but the returns are even less than advertised, this seems even more counterproductive. Still, pension funds continue to re-up their investments in private equity, and some have increased their allocation over time.

Rose: Yes, pension funds face a dilemma. U.S. law requires funds to comply with the principles of loyalty and impartiality to act in the best interests of their beneficiaries – according to the standards of what a "prudent man" would do – not in their own interests or those of a third party. Historically, this meant avoiding risky or speculative investments. But in 1974, Congress passed the Employment Retirement Income Security Act (ERISA) allowing pension funds to invest in stocks and other risky investments. And over time, the interpretation of what is "reasonable" changed. In particular, scholars in the "law and economics movement" argued that the prudent man rule should be defined only in terms of investments that should minimize risk – via diversification in portfolio investments – and maximize short-term returns – via investments that guarantee higher short term returns to the fund. This paralleled the trends in economics and management studies that argued the sole purpose of the corporation was to maximize returns to shareholders – typically measured by stock price.

In 2008, the Bush administration's Department of Labor issued "guidance" to strengthen this interpretation, stating that a fiduciary must only consider the economic interests *of the plan*, not other factors outside of these interests. That is, for example, factors such as whether the plan's investments result in job or wage loss for workers. Thus, while the plan's beneficiaries may not want investments to destroy jobs or Main Street companies, the interpretation of fiduciary duty puts the *plan first,* above *workers first*. Some legal scholars, however, argue that this interpretation is inconsistent with the original ERISA legislative intent (Webber, 2018).

In the meantime, pension funds have continued to invest – and increased their commitments – to private equity funds known to cause companies to go into bankruptcy – throwing workers out of jobs. And to reiterate, the best econometric evidence on this point shows that PE ownership leads to job loss or lower job and wage growth, compared to comparable publicly traded companies (Davis, Haltiwanger, Jarmin, Lerner, and Miranda, 2014; Appelbaum and Batt, 2014). Private equity owned companies are at least twice as likely to go bankrupt than are comparable publicly traded companies (Strömberg 2008; Ayash and Rastadz, 2019).

Jamie: I wonder how many members of pension funds know about this?

Rose: Well, they are paying pension fund managers to oversee their funds, so in principle the members shouldn't have to worry.

Jamie: So the contradiction of investing in PE was masked to some degree by rule changes that affected how pension funds were managed?

Rose: Yes, but since the financial crisis of 2008, which decimated pension funds, many have argued that maximizing fund returns is too narrow a definition of fiduciary duty. It may be the case as you suggested earlier that private equity and hedge funds are not the only sources of financial instability, but they contributed to the financial crash by creating high volatility and systemic risk, and led to billions of losses in pension funds that took years to recover. If pension funds choose to invest in risky private equity and hedge funds, which maximize short-term returns but undermine long term fund stability, then investing in these risky funds does not meet the standards of fiduciary duty (Lydenberg, 2014; Youngdahl, 2012). Pension funds need to take a broader set of criteria into consideration – criteria that include environmental, social, and governance outcomes.

Jamie: And transparency bears on this too if LPs cannot be sure exactly what GPs are doing and will do?

Rose: The lack of transparency in GP decision-making has been a major sticking point for the LPs for a decade or more. The association that represents LPs, the Institutional Limited Partners Association (ILPA) put out guidelines for better transparency in 2011, after the Great Recession led to a precipitous drop in PE fund performance. They recently updated and tightened those guidelines (ILPA, 2018), but GPs have virtually ignored them.

From a legal standpoint, the lack of transparency is also because by outsourcing all decision-making authority to the PE General Partners, the pension funds can't even know if they are meeting their fiduciary responsibilities. While pension funds may delegate management of their investments to a service provider, they must be able to monitor and ensure that their behaviour meets the high standards of fiduciary duty. But under the Limited Partner Agreement (LPA) that pension funds sign, they have no access to the kind of financial or other data they need to determine if the GPs are actually making decisions that are in the best interests of the fund. GPs, in the meantime, have a conflict of interest when they face situations in which one decision would benefit the LP investors, while another would benefit the PE firm. Case evidence provides examples in which the GPs have clearly put their own interests above those of their investors; and in some cases, GPs have stated that they are not responsible for whether the fiduciary responsibility to the LP beneficiaries is met (Appelbaum and Batt, 2016: 16).

Jamie: This keeps bringing us back to the fundamental issue of contradiction, which seems as much moral or ethical as it does rational or legal.

Rose: Well, the paradox of why invest at all is one that Eileen and I have tried to understand for several years. We wrote about it in a recent article (Batt and Appelbaum, 2020b), but many outstanding questions remain. This would be a great dissertation topic for someone to tackle.

The article reprises the economic arguments for "why invest", and as we have discussed above, they are not compelling given the widespread evidence that PE fees are excessive, PE fund performance has fallen, and the median fund doesn't beat the stock market any more. But the private equity industry uses a different metric – the internal rate of return (IRR) to measure its performance, and by that metric, which is flawed and subject to manipulation, their funds continue to outperform the market. Many fund managers also believe that even if the typical PE fund doesn't beat the market, they know which funds to pick – although as I mentioned before, research shows no persistence in fund performance over time.

Jamie: I guess they may also be benefiting from investor "yield anxiety"; returns on any standard investment have fallen in this century; financialization, Quantitative Easing, continual creation of liquidity etc., stand behind all kinds of problems.

Rose: Well, there are a shrinking number of well-performing publicly traded corporations to invest in. A more compelling reason, I believe, is that pension fund managers apparently want to believe the IRR return numbers, because these also serve their own interests – managers can claim they are doing the best they can and that their investment strategies follow the advice of their financial advisors – so they are fulfilling their fiduciary responsibilities. Of course, the financial advisors benefit financially the more pension funds invest in complex financial investments.

Jamie: Overall then there is a rationale even if there are not good reasons for pension funds to invest in PE?

Rose: In our paper, Eileen and I argue that institutional and political explanations play at least as important a role in the continuity of pension fund investing in private equity. Limited Partners are in a fundamentally asymmetric power relationship with private equity, and they are somewhat locked into a norm that was set decades ago. The “2 and 20” model, the 10-year illiquid investment period, the buyout model, the delegation of all decision-making authority to the GPs, the utter lack of transparency in GP dealings – these are all baked into the PE recipe with boiler plate legal language and this has legs. If LPs try to change the rules of the game now, the PE general partners can retort – why now when these arrangements have “worked” all this time? Or they can threaten to not offer the pension fund the opportunity to invest in the future. The institutionalized model weighs heavily in favour of the PE firms.

Jamie: Perhaps we should end on a positive note. In campaigning for his first election, Donald Trump was disparaging of finance capital and promised to end, for example, the special tax status of carried interest (taxed as capital gains not income). He didn’t do that, nor did he do anything substantive for the many “left behind” who voted for him. Do you envisage any of this changing when (if) Joe Biden becomes President? There are, of course, many other issues (e.g. Morgan, 2019), but Progressives and Green New Dealers, for example, see the climate and ecological crises as opportunities for change and the pandemic does not seem to have altered that. Is there scope for a different kind of private equity in this context?

Rose: Perhaps we can be cautiously optimistic, not just because there is a transition to a Democratic presidency; but more so because a strong coalition of black, Hispanic, and white young activists have galvanized the push for real change in the U.S. Black women were critical in the Democratic win, and progressive women have poured into lower level elected positions in cities and states across the country. The Biden picks look promising. And there is widespread commitment to overturning inequality and poverty and launching a green new deal.

My concern is that the movement for financial reform is less well developed. While anti Wall Street rhetoric is in the air, most people don’t understand the ways in which financial actors, such as private equity, hedge funds, and the billionaire class, are responsible for the inequality, poverty, and continued racial divides in the U.S. The linkages are not transparent. So, even if the Democrats take over both houses of Congress and are able to pass progressive social or healthcare policy, the drive for real financial reform rests with a handful of leaders – like Elizabeth Warren, Bernie Sanders, Katie Porter, or Alexandria Ocasio-Cortez. Having said that, proposals for financial reform are bubbling up – The Accountable Capitalism Act by Warren, for example, and proposals for a public investment bank, public infrastructure banks, and a green new deal.

On the upside, a growing number of unions have set up “capital strategies departments”, to monitor financial actors and put pressure on pension funds to exit their private equity and hedge fund investments. It's also exciting that a small industry of independent researchers and investigative journalists is emerging who are exposing the worst excesses of private equity – many of whom I've cited in our conversation. Eileen and I hope that we've contributed in a small way to helping this network grow. The groups include non-profit research and advocacy groups like the Americans for Financial Reform, the Private Equity Stakeholder Group, the Consumer Federation of America, the Center for Economic and Policy Research, Better Markets, Public Citizen, and the foundation Institute for New Economic Thinking – to name a few. Mainstream media also are catching on – including the *New York Times, Bloomberg,* the *Financial Times,* and even the *Wall Street Journal,* which have increasingly highlighted private equity's bad behavior. The particularly egregious surprise medical billing practices that I mentioned earlier, spearheaded by PE firms, garnered widespread media coverage and disapproval by Democrats and Republicans alike. Thus, public and political awareness is growing.

I think the most promising solution for financial reform in the U.S. is the establishment of a permanent institution similar to the New Deal's Reconstruction Finance Corporation (RFC). Cornell law professor, Saule Omarova, has written extensively about the need for a National Investment Authority (NIA), (Omarova, 2020). The U.S. has effectively used this type of institution in the past to coordinate massive flows of public and private capital into every sector of the economy – not only during the New Deal, but also in World Wars I and II and their aftermath. An NIA could provide a permanent institutional structure with a dual mission: To organize and mobilize the nation's economic resources in response to systemic crises; and to coordinate and finance ongoing public and private investment in critical public infrastructure and socially inclusive and sustainable economic growth. This vision, of course, is aspirational; but only this type of radical change will begin to turn around the problems created by finance capital in the last several decades.

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