

# The evolving European system of corporate governance: implications for worker participation

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## Summary

*This article contributes to the current battle over the character of the evolving European system of corporate governance. The claims of proponents of the shareholder value model, which has been hegemonic in European policy-making circles over the past decade, are subject to a critical examination. In particular, the claims of the governance superiority of private equity, one of the extreme expressions of the shareholder model, are shown not to hold empirically. The concept of the sustainable company is proposed as an alternative to the shareholder value model, both because of its explicit commitment to a multidimensional understanding of welfare, and because of its extension of worker participation beyond traditional trade union concerns.*



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## Sommaire

*Cet article contribue au débat actuel sur la nature du système européen de gouvernance d'entreprise en plein développement. Les revendications des partisans du modèle de la valeur actionnariale, qui a été hégémonique dans les cercles politiques européens durant la décennie passée, sont soumises à un examen critique. L'étude montre en particulier que revendiquer la supériorité du capital-investissement en matière de gouvernance, une des expressions extrêmes du modèle actionnarial, ne tient pas la route dans les faits. Le concept d'entreprise durable est proposé comme alternative au modèle de la valeur actionnariale, parce qu'il implique un engagement explicite en faveur d'une compréhension multidimensionnelle de la prospérité et qu'il étend la participation des travailleurs au-delà des préoccupations syndicales traditionnelles.*



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### Zusammenfassung

Dieser Beitrag liefert einen Beitrag zur aktuellen Auseinandersetzung über die Entwicklung des europäischen Systems der Corporate Governance. Die Argumente der Verfechter des Shareholder-Value-Modells, das in der europäischen Politikgestaltung des letzten Jahrzehnts dominierte, werden kritisch analysiert. Insbesondere das Argument der Überlegenheit der Private Equity, einer der extremen Ausdrucksformen des Shareholder-Ansatzes, im Bereich der Governance lässt sich empirisch nicht nachweisen. Das Konzept des nachhaltig orientierten Unternehmens wird als Alternative zum Shareholder-Value-Modell vorgeschlagen, einerseits weil es sich ausdrücklich zu einem multidimensionalen Verständnis der Sozialthematik verpflichtet, und andererseits weil es die Beteiligung der Arbeitnehmer über traditionelle Gewerkschaftsbelange hinaus beinhaltet.



**Keywords:** corporate governance, shareholder value, worker participation, trade unions, private equity, sustainability

## Introduction

This article examines the current debate on corporate governance reform in the European Union, from the point of view of the prospective role for worker participation.<sup>1</sup> What is striking about the current debate is the extent to which the US corporate governance system is seen by European policy-making elites as definitive of ‘international best practice’ – despite Enron and other financial scandals, and the lack of solid evidence showing that the US system is economically superior. Few innovative ideas have been offered regarding the improvement of corporate governance in the very different institutional context of the European Union, where there is 1) a commitment to strengthening the rights of worker information, consultation, and participation in the company, and 2) a much higher level of concentration of share ownership and less participation by households in the stock market.

This situation is of course of great concern to trade unions, since the US system of corporate governance focuses on the interaction between management and shareholders, to the exclusion of the representation of interests of workers and other stakeholders (Greenfield 1998). This article focuses on the issue of how trade unions could have

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an influence upon this debate and what concrete measures unions could support in the construction of a corporate governance system more suitable to European conditions.

The first section looks at why there is a tendency in the economic and social sciences to argue that there is ‘one best’ system of social organisation, and why this game is so popular in the media and policy-making world. The second section critically examines the performance of the US system of corporate governance relative to the ‘stakeholder’ system predominant in Europe. It shows that the literature has failed to make a convincing link between the institutional features of the US corporate governance system and superior economic performance. The third section focuses on the role of private equity funds, which are playing an increasingly important role as owners (in part due to regulatory changes based on the shareholder value model) and in important ways challenge the European social model of worker participation and long-term orientation. The fourth section discusses the idea of the sustainable company as a possible alternative to the shareholder value model of company organisation which would be more in the interests of workers, the environment, and society as a whole.

## Battle of the systems

On the surface, corporate governance is a highly technical subject dealing with multiple issues in the fields of corporate law, securities regulation, corporate finance and industrial relations. Deeper down, however, the basic issue underlying corporate governance reform is the fundamental choice between two different competing conceptions of the firm. In the *shareholder model*, the firm is a private association of shareholders, who come together and found a firm with the intention of increasing their wealth. This firm purchases the factors of production (labour, fixed capital, etc) necessary to increase this wealth. The clear primary responsibility of managers hired to run the firm is to the shareholders, and to the mandate of increasing the value of the firm.

In the *stakeholder model*, in contrast, the firm is a *community* in which shareholders are only one of a number of other stakeholders in the firm. The public has an interest in regulating the firm so that the different stakeholders have a ‘voice’ in the decision-making process, and that a reasonable balance in the goals pursued by the firm is achieved, not just the maximisation of profits. The US is the country where the shareholder model is most advanced, whereas most European countries have developed a stakeholder model of corporate governance.<sup>2</sup>

For roughly the last decade the US shareholder system of corporate governance has been hegemonic in Europe, and indeed in the rest of the world. Many actors in business, policy-making, and academic elites at the national and EU level have argued that

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2 The UK has traditionally been lumped together with the US in this typology. However, there is a growing literature suggesting that the UK may be somewhere ‘between’ the US and continental Europe – see for example Pendleton (2005).

this system is superior and have actively tried to transfer aspects of it. Although the reference to the US is sometimes disguised under the cloak of ‘international best practice’, nevertheless the origin of this system is clear.

What is striking about ‘corporate governance reform’ in Europe is how few innovative ideas have been proposed by policy-making elites, despite the fact that labour and capital markets in Europe are organised on the whole quite differently than in the US. In particular, information, consultation and participation within the company have been defined as ‘fundamental rights’ in the European Union, and most EU countries have legal rights to workers’ representation on the boards of at least a subset of large companies (Höpner 2004; Kluge 2005). Furthermore, the US system is oriented to the interests of small shareholders. In Europe, however, ownership of European listed companies is much more concentrated, and only a minority of households own stocks.

The tendency to identify ‘one best system’ is unfortunately deeply engrained in the scholarly world. This has both methodological and reputational reasons. In economics, the predominant methodology tends to define optimal ‘single peaks’ in economic performance (Freeman 2000). In the social sciences ‘ideal types’ are typically used to analyse different countries or other objects of analysis. The methodology of ‘ideal types’ involves the identification of two or more groups, in which there are sharp differences between countries along one or more dimensions. The tendency frequently is to emphasise the advantage of one type over the other.

On the reputational level, even though social and economic reality is quite complex, a strategy of taking simple and extreme positions in one’s own work is often a promising strategy for scientists wanting to create a reputation within their academic circles. This also applies to the media and policy-making worlds, where those offering clear (if oversimplified) solutions are more likely to be heard and to appear convincing. This is particularly the case if the policy solutions advocated are based on practices in other countries, where the audience has little or no direct knowledge. Differentiated analysis involving more variables and more conditional approaches tends to be overheard in the cacophony of policy advice offered.

Long-term observers of the academic and policy-making worlds will recall that we have seen many cycles of fashions in terms of perceptions of the ‘one best system’ (see Table 1). In the 1950s the Soviet system was considered superior by many because of its supposed ability to force high levels of investment and demand in a post-Depression era. In the 1960s indicative planning appeared to be successful in promoting the rapid industrialisation of France, and was tried in a number of countries. In the 1970s the corporatist countries, such as Sweden and Germany, seemed to be best able to deal with a macroeconomic environment characterised by stagflation. In the 1980s Japan with its system of planning ministries and state-administered credit system was considered unbeatable, with books even describing the system as a miracle. In the early 1990s up until the Asian crisis the Asian Tigers were thought to have the right policies leading to above-average growth rates. After having been criticised as too market-oriented and

short-termist in the 1980s, the US system had a resurgence in the 1990s and is now the hegemonic economic model.

**Table 1: Leading national models after World War II**

Period	Leading 'best system'
1950s	Soviet planned economy
1960s	French indicative planning
1970s	Corporatist countries (Nordic countries, Austria, etc)
1980s	Japan, Germany
Early 1990s	Asian Tigers
Mid-1990s to now	US neoliberal model
Next model	?????

Source: Adapted from Freeman (2000).

What explains the current hegemony of the US corporate governance system? Certainly the self-interest of important actors in Europe plays an important role here. It would be naïve to ignore the much higher levels of executive compensation in the US system as a motivating factor. Furthermore, many large financial services providers have a strong financial interest in shifting Europe more in the direction of the US system. The large banks, for example, have been making less money on traditional lending activities, and are interested in increasing their fee-based earnings, from investment banking activities (such as hostile takeovers and mergers and acquisitions deal structuring) and asset management (such as administration of company pensions). Also, some state elites have decided that they no longer want to take responsibility for state enterprises, or desperately need the revenues from privatisation, and find the supposed superiority of the US system of stock market governance to be an appealing justification for privatisation.

However, the strongest fact these elites have had on their side in the last decade has been the stronger economic performance of the US (and of other countries 'close' to it in terms of economic organisation, such as Canada, Australia and the UK). The substantially higher economic growth rates and lower unemployment rates in the US and its 'fellow travellers' in the past decade have created a climate in which it has been very difficult to criticise the US system and argue for alternatives. Much as the Japanese and German systems in the 1980s could 'do no wrong', the whole complex of US institutions have enjoyed the 'status of the blessed' throughout the 1990s and the early 21st century.

## **Blemishes of the shareholder system and achievements of the stakeholder system**

What is to be done, given the difficult context outlined in the last section? This section argues that one possible response is a three-part task involving: 1) exposing the lack of evidence that elements of the US system of corporate governance have actually led to

better economic performance, 2) understanding the causes of above-average, but arguably non-sustainable, growth in the US economy over the past decade, and 3) looking at the neglected achievements of the stakeholder system.

## Lack of solid evidence on the effects of corporate governance

Despite the widespread belief that features of the US system of corporate governance lead to better firm performance and superior growth, there actually is a serious lack of evidence backing up this assertion. A number of large-scale comparative studies done by academics working in the 'Law and Finance' perspective have been the most widely-cited evidence in support of the assertion that 'common law' systems like the US, which provide high levels of transparency, strong legal enforcement, and strong minority shareholder protection, are the best at promoting financial system development and growth (La Porta 2003; La Porta *et al.* 1997; La Porta *et al.* 1998).

These studies, however, have come under rather severe criticism. Siems (2004) shows that the methodology used in the studies is on rather shaky ground. Furthermore, in a detailed historical study of the UK, Franks *et al.* (2003) show that the order of development suggested by the Law and Finance academics (i.e. good governance leads to increased investment) may actually be reversed. Current corporate governance structures in the UK actually arose *after* a large number of institutional investors were active in the market and demanded these measures.

Company level studies have also failed to find significant or consistent results linking corporate governance and firm performance, even for three of the characteristics considered to be central to good corporate governance: board independence, split roles for the CEO and chair, and board size (Heracleous 2001). Bebchuk *et al.* (2004) for example find that 18 of the 24 corporate governance characteristics used by the Investor Responsibility Research Center (IRRC) to make negative recommendations on investing in companies actually had no significantly negative impact on company value and share price. Larcker *et al.* (2004) conclude that: 'Overall, our results suggest that the typical structural indicators of corporate governance used in academic research and institutional rating services have very limited ability to explain managerial behaviour and organisational performance.' An earlier survey of literature done by two researchers at the OECD concluded that the evidence on firm performance showed that '... there is no single model of good corporate governance, and both insider and outsider systems have their strengths, weaknesses, and different economic implications' (Maher and Andersson 1999).

## Non-sustainable sources of economic growth

If corporate governance institutions cannot account for superior firm performance and growth in the US, what can? The point on which the US is most vulnerable to criticism is that high economic growth since the early 1990s has, at least in part, been based on

macroeconomic policies which are unsustainable in the long term. This is a point upon which an increasing number of Wall Street and academic economists in the US would agree upon. The (to some extent interrelated) factors leading to this unsustainably high growth rate include:

- an excessively loose monetary policy, chosen by the US central bank (Federal Reserve Board) as the preferred response to a series of financial crises (1987 crash, early 1990s crisis of the US banking system, 1994-1995 Mexican peso crisis, 1997-1998 Asian crisis, 1999 fear of a Y2K-related disruption of the international bank payments system, and post-2000-2002 stock market crash) rather than a stronger regulation of speculative tendencies in US financial markets;<sup>3</sup>
- a decrease in the household net savings rate to 0.2%, which represents a huge consumer-led stimulus to the economy;
- a massive build-up of debt<sup>4</sup> by companies, households and government, from US\$13.5trn in 1990 to US\$36trn in 2004. Outstanding debt now accounts for more than 300% of the US GDP;
- a high and rising US trade deficit, which has steadily increased to about 6% of GDP in annual terms, and which also represents a massive stimulatory influence for the economy.

The most visible indicator that the international investment community has lost faith in these policies is the sharp drop in the value of the dollar of about 40% (measured against a basket of major currencies) since the stock market peak in early 2000, and the belief that the dollar decline still has a long way to go.

## Achievements of the stakeholder system

The flip side of the coin is that the European stakeholder model should be seen as 'better than its reputation'. The achievements of this model have been to some extent hidden by the lower growth rates in Europe. These lower growth rates have in part been caused by tight monetary policies pursued by central banks in response to the inflationary financing of German unification and the attempt to create credibility in the run-up to the introduction of the euro (Carlin and Soskice 1997). A short list of the main advantages is:

- fewer financial excesses and scandals than among US corporations, and a significantly lower debt level;<sup>5</sup>
- less social inequality between top management and workers. The ratio of average

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3 In the 1990s investors called this policy preference the 'Greenspan put', i.e. the assurance that the Federal Reserve Board would protect investors in the stock market from 'downside risk' by loosening monetary policy and increasing liquidity in the system in response to financial crises.

4 For a critique of the massive increase in US debt see e.g. Baker (2004).

5 A recent paper by Coffee (2005) argues that the *nature* of financial scandals in the US and Europe is also significantly different. Financial scandals in the US, such as Enron, were mainly caused by attempts to mislead investors. In the US system there are considerable financial incentives for top management to do so. Scandals in Europe (e.g. Parmalat) were mainly caused by management's attempt to steal.

pay of the top 100 CEOs in the US to the average pay of manufacturing workers reached more than 1000 to 1 in 1999 during the peak of the bubble (Lannoo and Khachatryan 2003). The ratio of the average pay of all US CEOs to average manufacturing workers' pay was reported to be 44:1 at around the same time. The same ratio in Germany was 17:1, in Sweden 21:1 and in France 32:1 (Osberg and Smeeding 2003);

- the more modest increase in top management pay in Europe also means that there is more money available for investment and shareholders in European companies. Management pay in the US has increased at such a rate that the pay of the top five managers of listed companies currently accounts for about 10% of profits of these companies, i.e. quite a significant proportion of profits (Bebchuk 2005: 1370);
- proven stability in a slow growth environment. The US will likely also develop such a slow growth environment, and it is not clear how stable the corporate sector will be in this environment (e.g. difficulties in repaying debt, disappointing investors' high growth expectations, etc); and
- a greater ability to integrate diverse national cultures and industrial relations environments. The international management literature has shown that US corporations tend to have a much more unitary structure, which they impose in different countries regardless of the institutional context.

When the US model in fact falls from grace – as all leading models inevitably do – then the European stakeholding model should have a strong candidacy for the position as the new leading model.

## The role of private equity funds in corporate governance

As the amount of capital under control of, and the number and size of investment deals made by, private equity firms reaches new highs each year, and as the location of private equity investment has spread outside the Anglo-Saxon countries, the debate on the economic and social impact of private equity has intensified. In conjunction with the activities of hedge funds, which have also experienced a rapid increase in number and amount of administered capital in the beginning of the 21st century, the rise of private equity has also triggered an academic discussion on whether a new era of 'finance-led capitalism' has emerged, in which financial criteria have (re)acquired dominance over 'real economic' and social criteria in investment and production decisions (Boyer 2000; Stockhammer 2007).

Two views have dominated the debate on interpreting the economic and social impact of private equity.<sup>6</sup> The first view, underpinned especially by the work of Michael Jensen, has focused on the positive impact of private equity (Jensen 1988; Jensen 1989; Jensen

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6 The exact definition of private equity varies from country to country, in some cases just including 'buyouts' (i.e. transfer of ownership, and in many cases change in top management, of established firms), in other cases including 'venture capital' (i.e. high-risk finance for start-up firms). In this paper the term private equity will be used solely to refer to buyouts, excluding venture capital activity.



and Meckling 1976). According to this view, private equity can in many cases offer a superior solution to governance problems within the firm. In cases where management is inefficient and/or reaps private gains at the expense of shareholders, private equity can better align the incentives of shareholders and management, resulting in a more efficient allocation of capital and possibly greater production efficiencies. As a result, the value of the firm increases, benefiting shareholders. Society is also supposed to gain, through less expensive and/or improved goods or services, and also from more jobs (or at least, more secure jobs/fewer job losses).

The opposing view, which until now has been more clearly articulated in the public debate than in mainstream political economy, focuses on the negative impact of private equity. According to this point of view, private equity firms are 'locusts', whose gains come at the expense of other social and economic interests: 1) 'financial engineering' results in private equity gains at the cost of debtors, other shareholders, and the future interests of employees, simply due to changes in the financial structure of the firm (either through an increased debt/equity ratio, or through an extraction of resources through special dividends or other means); 2) operational efficiency gains are achieved by following the 'low road', i.e. reducing wages, cutting employment, and possibly reducing R&D and capital investment in the short term to increase profits at the expense of long-term innovation (Socialist Group in the European Parliament 2007); and finally 3) tax subsidy for debt relative to equity allows for wealth transfers from taxpayers to private equity investors.

The answer as to which of these opposing views is correct is largely empirical, and requires a detailed review of the relevant studies. Not surprisingly, the private equity industry has sponsored studies which show not only that private equity investors enjoy financial returns above and beyond what they could get on the stock market, but also that society at large benefits, particularly through job creation. Most studies which attempt to compare private equity investment under realistic assumptions with returns that would be gained from investment in the broad stock market, however, have shown clearly that private equity investors do not really enjoy higher (risk-adjusted) financial returns. Furthermore, an analysis of the more methodologically sophisticated studies on the real impact of private equity shows that there is not a clear net benefit for society at large, at least when discussing the employment and wage impact of private equity investment.

As a general note, large-scale quantitative studies on the economic and social impact of private equity have been rendered quite difficult due to the lack of transparency of the private equity industry. On the fund level, private equity funds are generally not forced to publish data accessible to the public at large, and the quality and accuracy of information that can be gained through (as a rule quite expensive) databases is questionable (see below for a discussion of this). On the company level (i.e. level of the firms that private equity funds invest in) the reporting requirements for private (non-listed) companies vary considerably from country to country, as does the mode in which this information is made available to the public. Furthermore, companies often change name when they change

ownership in the context of a private equity transaction. As a result, it is virtually impossible (the only partial exceptions here are the US, and to a lesser extent the UK) simply to download a large data set of private equity-related companies that contain more information than sector, address, date of investment, etc from the typical online data services – quite unlike the case for other kinds of studies, such as of listed companies, for which detailed information is available due to extensive publicity requirements.

This lack of large-scale quantitative data has forced empirical studies of private equity to follow one of the following three strategies: 1) use the standard databases while accepting the accompanying danger of biased results, 2) use self-reported or ‘private’ data from private equity funds and/or institutional investors in private equity, or 3) use case studies.

The first two strategies run the danger of providing overly-optimistic estimates of the impact of private equity (as the more scientific studies in this group of studies admit), due to a number of systematic biases: first, the ‘survivorship bias’, since failed portfolio companies (in the worst case involving a total loss of jobs) are as a rule excluded from the analysis; secondly, there may be additional ‘selection bias’, as the better firms among the survivors are over-represented. Finally, in the case of self-reported data, there is a strong danger of ‘reporting bias’, since the reporting private equity firms understand the potential public policy impact of the study and their self-interest in exaggerating the positive impacts of private equity. The third strategy also runs the danger of examining non-representative cases, particularly when there is quite a small sample size.

## Employment and wage impact of private equity

Estimates of the ‘real’ impact of private equity investment on companies (employment and other real impacts such as wages and profits) vary quite widely from quite positive to negative. The most positive studies have been produced by the venture capital industry (associations or consultants for the industry). These optimistic studies include:

- British Venture Capital Association (BVCA) series of annual studies entitled ‘The Economic Impact of Private Equity in the UK’. The 2006 study (BVCA 2006) analysed 1 457 answers from a survey of 5 700 potential respondents from buyout-financed or venture-capital financed companies. This study has the most optimistic estimate of employment growth in buyout-financed companies (an average of 7% employment growth per year in the period under examination, the five years up to 2005/2006). Sales growth was estimated at 10% per year and R&D investment growth at 21% per year. In addition to the survivorship and potential self-reporting bias, another major weakness in this study is that the methodology used was not revealed in detail.
- Ernst & Young (2007) conducted a study of the 200 largest private equity exits in North America and Europe in 2006 (100 largest in each of the two regions). For buyout-backed firms in Europe an estimate of 5% employment growth per year was derived. Symptomatic of transparency problems in the private equity industry

is the fact that Ernst & Young were able to get detailed financial information on only 112 of these 200 transactions, even though they were all rather large. The survivorship bias in this study is exacerbated by serious selection bias: the largest (by deal value) exits were chosen, leading by definition to an over-representation of the most successful deals in this sample.

- A study sponsored by the European Venture Capital Association (EVCA) but performed by university researchers (Achleitner and Kaserer 2005) had a less positive estimate of employment growth in buyout-financed companies in Europe of an average of 2.4% per year. This however was significantly greater than the average employment growth of 0.7% in the same time period for companies as a whole in the EU-25.
- With regard to the German situation, a study by PriceWaterhouseCoopers in cooperation with the German venture capital association (BVK) is overall positive on the impact of private equity, but as the most positive effects come from venture capital, the specific results for buyout investments can be seen in a more critical light (PWC 2005). Buyouts excluding 'turnaround situations' (i.e. companies that make significant losses when they are purchased) averaged 4.4% employment growth 'per financing round'. Since buyout financing rounds often last considerably more than a year, this average employment growth rate would be in the 1-2% per year range. Profitability (EBIT) for these companies actually decreased by 1.9% per year. For buyouts involving turnaround situations, profitability on average improved considerably, but an average of 29% of employment was lost. In conjunction with the survivorship and self-reporting bias involved in this sample, this study would suggest that employment is not increased in buyout-financed companies in Germany and that operations/profitability are not improved in normal (non-turnaround) buyout situations. An open question is whether the studies on the impact of private equity in the UK and Europe are too optimistic, or whether the impact of private equity in Germany is significantly less positive than in the UK and Europe as a whole.

More methodologically sophisticated recent studies have come to somewhat less optimistic assessments of the real impact of private equity. Practically all of the newer academic studies have involved one or more researchers from the Centre for Management Buyout Research in Nottingham, UK, which is financed by the private equity industry. Some of the studies have relied at least in part on self-reported data from private equity funds gathered under conditions of confidentiality. Even so, the studies have come to mixed conclusions regarding the real impact of buyouts in the UK, particularly at the plant level.

- A plant-level study of UK management buyouts (MBOs) found that productivity increased substantially (70% in the short term, 90% in the long term), together with an output reduction of about 50% and an employment reduction of about 61% (Harris *et al.* 2005).
- A firm-level study of MBOs and management buy-ins (MBIs) in the UK (Amess and Wright 2006) found that employment relative to non-buyout firms increased on average for MBOs (0.51% per year) but decreased for MBIs (-0.81% per year).

Furthermore, the impact of private equity investment on wages was negative for both MBOs and MBIs relative to non-buyout firms (-0.31% and -0.97% per year, respectively).

An alternative research strategy has been to focus on case studies of private equity investments. In Germany, the Hans-Böckler-Stiftung (HBS) has sponsored a number of case studies of private equity investments, as well as overviews of private equity and hedge fund activity in Germany (available on the homepage [www.boeckler.de](http://www.boeckler.de)). An expert report provided by Kaserer *et al.* (2007) for the German federal government also analysed five buyout cases in Germany: Wincor Nixdorf AG, Grohe AG, Celanese AG, Sulo GmbH, and Premiere AG.<sup>7</sup>

One of the most important findings of these case studies is that there is a great deal of heterogeneity between the strategies of different private equity firms as well as among individual portfolio companies. The Kaserer *et al.* (2007) expertise is generally positive on private equity, claiming that the economic impact in five of the six buyout cases examined was positive. Wincor Nixdorf in particular appears to be one of the most successful private equity stories in Germany. Only Celanese AG, which was taken private in 2004 only to be brought back on to the stock market in 2005, appeared to be a case where the value driver was mainly financial engineering/arbitrage. The HBS studies, which also focus more on industrial relations and the employment impact of private equity, are as a whole more critical, although positive examples of private equity investments are also identified. The first investor in Grohe AG, for example, allocated more money to capital investment and R&D. Generally, however, works councillors and trade unionists report a serious deterioration in the degree to which employee rights to information and consultation are respected when a private equity firm steps in.

A large-scale quantitative study of Germany would need to make a serious effort to gather 'objective' financial data from annual reports, based on selection of companies at the time of the initial private equity investment, as well as an accompanying survey of works councillors/trade unionists to evaluate the quality of industrial relations accompanying these investments, in order to judge whether the 'high road' or the 'low road' to restructuring was followed.

## Returns for private equity investors

The lack of a strong case for private equity from the point of view of employment and wages is not surprising for the critical view of private equity. However, a result that should be surprising for both the supportive (e.g. Jensen) and the critical view is that, on the whole, financial returns for private equity investors have not outstripped investments in the broad stock market, neither on a relative nor in particular on a risk-

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<sup>7</sup> In addition, one case of venture capital financing (United Internet AG) and one case of a property market related buyout (Gagfah) were analysed.

adjusted basis. One of the key justifications for private equity is that investors can gain a superior return from this form of ‘alternative investment’ relative to other risky investments. For financial economists, not only the absolute return that can be gained from a specific asset but also the variability of this return (i.e. the amount by which it can deviate up or down each year) is important in measuring investment performance. If two alternative assets have the same absolute return over a period of time, the one with the lower variability will be considered as having the superior risk-adjusted return. If the difference in variability is great enough, an asset with lower absolute return but also lower variability may be superior on a risk-adjusted basis than the asset with a higher absolute return but also a much higher variability.

Supporters of private equity claim that private equity can generally be expected to have a return in the 10-15% per year range, i.e. significantly higher than the long-term historical return of 7-8% from the stock market and 3-5% from the bond markets. Furthermore, private equity should have a lower variability than the stock market, since incremental gains can be realised each year. Finally, private equity returns should be uncorrelated with other broad asset classes such as the stock and bond markets. A surprising result is that none of these three claims appears to be true.

An important concept for examining the returns to private equity relative to other asset classes is the idea of PME (public market equivalent). Since private equity funds do not draw down 100% of the committed capital immediately upon initiating investment, and also return invested capital on a piecemeal basis up to liquidation of the fund, important questions for comparing returns are: 1) where the committed but not yet drawn-down funds are invested up until the time they are called for by the private equity fund, and, furthermore, where returned funds are invested until the private equity fund is liquidated, and 2) what the exact comparison benchmark should be.

The PME concept assumes that the benchmark against which private equity should be compared is investment in a broad class of assets that can be bought and sold on the market – typically in a broad stock market index such as the S&P 500 index (five hundred largest companies on the US stock markets) or the MSCI Europe index (largest European listed companies). Furthermore, capital that is committed but not yet drawn-down by the private equity fund is also invested in this broad market index, and realised capital that is returned by the private equity fund to the investor is reinvested in this broad market index.

Using this methodology, a PME value of 1 would mean that an investment in private equity would gain exactly the same return as an investment in a broad market index. A PME value of 1.2 would mean that returns in private equity were 20% higher than the market index, whereas a value of 0.8 would mean that returns were 20% lower.

Although this calculation method is data-intensive due to the need to calculate returns for quite a few data points for each fund, a number of recent studies have applied this method:

- A study by Kaplan and Schoar (2005) of private equity funds using the Venture Economics database (recently purchased by Thomson) and the S&P 500 as a benchmark found (net of management fees) for buyout funds a median PME return of 0.80 and average of 0.97 with equal weighting of each fund and a median PME return of 0.83 and average return of 0.93 when weighting funds by size, i.e. all results were less than one.
- One of the most methodologically sophisticated studies to date on the issue of private equity returns found not only a systematic bias in favour of better-performing funds in the publicly-available databases but also a strong tendency to overstate returns due to the practice of retaining 'living deads' on the balance sheets of private equity funds (Phalippou and Gottschalg 2007). These are firms which are for the most part practically no longer functioning (e.g. they have not generated any cash flow in the past few years), but are still retained on the balance sheet of the private equity fund. These 'living deads' overstate overall private equity fund performance by about 7%. Correcting for these two factors, overall private equity average performance for buyout funds is 0.95, i.e. an underperformance of the S&P 500 over the period examined of -1.65% per year.
- Another of the more sophisticated of the studies on private equity returns (Diller and Kaserer 2007) examined a sample based on all private equity funds that had been entirely liquidated as well as samples with residual values (i.e. 'living deads') of less than 10% and less than 20% of total capital. For the formally liquidated buyout funds the PME had an average value of 0.90 and a median value of 0.89. For the samples with less than 10% and less than 20% non-liquidated values the average PME returns were 0.94 and 1.06, respectively, and the median PME returns were 0.86 and 0.92, respectively. In other words, with the exception of the average performance of private equity funds with 'living deads' of up to 20% of the fund value, all estimates were less than one.

In addition to the incorrectness of this first claim (i.e. that private equity buyout fund relative returns beat the stock market), a second claim made by private equity supporters also appears to be incorrect, namely that the relative volatility of private equity returns is lower than the stock market. This claim was examined by comparing the volatility of stock market returns on the S&P 500 and MSCI Europe with the volatility of private equity fund returns estimated by a variety of studies (Kaserer *et al.* 2007: 183-184). In all cases the volatility of returns from buyout funds (both average and median returns) exceeded the volatility of the S&P 500, and in most cases they also exceeded the volatility of the MSCI Europe index.

Finally, a third claim of private equity supporters, i.e. that private equity returns are not highly correlated with other asset classes such as stocks and bonds, also does not appear to hold. A study of the drivers of private equity fund performance showed that private equity fund returns are highly correlated to both the level of interest rates and the trajectory of the stock market (Phalippou and Zollo 2006).

## The sustainable company as an alternative model?

In addition to a critical analysis of the shareholder value model it is also important to ask the question of what alternatives might exist. One possibility is the new concept of the ‘sustainable company’, which is increasingly being discussed in Europe. This model of corporate governance promises to support the achievement of a number of key goals, including the Lisbon strategy and a reduction in environmental deterioration, while at the same time advancing the practice of worker participation, a central element of the European social model.

The sustainable company is organised differently from the shareholder value model on a number of dimensions:

- The sustainable company is based on a multidimensional concept of sustainability, which includes not only environmental goals (e.g. reduction in carbon dioxide emissions) but also social (including health and safety), employment and training, and financial goals.
- The sustainable company is oriented towards long-term investments in human capital and R&D, and regards high levels of debt as a danger to the long-term viability of the company, rather than as a ‘disciplining tool’ for management.
- The first step in the development of the sustainable company is the development of a comprehensive reporting system on sustainability indicators for the company. This system is developed with the participation of key stakeholders (in particular workers), and builds in learning and improvement through an annual feedback process. An example of an international standard which could be used for organising this process is AA1000 AS (AccountAbility 1000 Accounting Standard), which is already used in a number of companies.
- A second developmental step is the agreement between management and stakeholders on concrete sustainability goals and a timetable. Furthermore, to align ‘management interests with stakeholders’ a third step would be to tie a portion of annual management pay to the achievement of these goals.

The concept of the sustainable company is relatively new, and few examples of companies fully developed along these lines exist (TUSDAC/DEFRA 2005). However, a number of practices are spreading, particularly a more multidimensional concept of sustainability reporting, and the external verification of reports. A number of companies (particularly in France) are also including stakeholders in the development of reporting systems, and companies in the Netherlands and UK have also tied management pay to the achievement of environmental and health and safety goals. The concept of the sustainable company also appears to be gaining support in countries where the concept of social partnership is not extensively developed.

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