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Ownership Matters: Private equity and the political division of ownership

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**Ownership Matters:
Private equity and the political division of ownership**

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Abstract

This article returns to the issue of how ownership matters. It does so by developing an argument about private equity in present day capitalism and then presenting empirics which show how the financier general partners in private equity have developed a political division of ownership which reliably redistributes cash to enrich general partners regardless of performance. From this point of view, private equity represents not ownership with control for strategic decision and operating efficiency but the control of ownership through constructing a hierarchy of ownership claims for debt and equity suppliers. The division of ownership remains a source of advantage after the change of conjuncture since 2007 and so the article concludes by arguing for a new policy focus on the position (not the identity or motives) of the general partner as owner.

Key words

Business model, Financialization, Ownership, Private Equity.

Ownership Matters: Private equity and the political division of ownership

1. Introduction

Since Hobbes and Locke rationalised possessive individualism, all kinds of economic and political theories have recognised, constructed and debated the importance of ownership and property in different kinds of capitalism. From Tawney (1921) via Berle and Means (1932) and Galbraith (1967) to agency theorists like Jensen (1993), the discussion of owner identities and different forms of ownership has been central to twentieth century debate about what capitalism is and should be (Erturk et al, 2008: 45-162). Thus, 1960s ideas about a new kind of managerial capitalism diagnosed a supposed separation of ownership and control in giant corporations; while 1990s ideas about the scope for better governance of these corporations prescribed a more active role for shareholders who should exercise their ownership responsibilities. Historically these debates have been constructed through a series of overlapping oppositions about active versus passive ownership, rights and responsibilities, title versus control. In much of this discussion ownership is presented as a have or have not condition which is assumed to be unitary like some thing possessed. But this is manifestly not so when ownership has long been legally divisible, and can be reassembled into different parts and combinations to create several different kinds of owners around one owned thing. Thus, a nineteenth century landowner could rent to a tenant farmer while separately leasing sporting rights and retaining mineral rights.

This point about the divisibility of ownership becomes important if we wish to understand present day financialized capitalism. Our argument is that elite intermediaries in financialized capitalism have learnt how to develop the division of ownership actively for their private advantage and with ambiguous social outcomes. In this article we show how private equity (PE) constructs a hierarchy of claims which work in the interests of the PE general partner, a financier at the apex. PE is not a special case, because hedge funds and new activists augment their power to force strategic moves and realise profit by renting share voting rights from pension funds which own the shares, or by entering into a contract for difference, an equity derivative which allows investors to gain from share price movements without owning the underlying share. We argue that in the case of PE the rationale for such divisions is not ‘economic’ efficiency but ‘political’ redistribution of crystallised gains to the general partner regardless of performance and with limits on downside risk. In pressing this interpretation of ownership and capitalist hierarchy, we are in a free hand way transposing Marglin’s (1974) classic insights about the political division of labour because the PE general partner figures in our analysis in much the same way as the ‘putter out’ in the industrial revolution figures in Marglin’s analysis.

The article develops this case over five sections. The first two sections set up the argument by establishing a crucial distinction between ‘ownership with control’ which is the narrative defence of PE against its critics and the ‘control of ownership rights’ which is the undisclosed business model of PE for the advantage of the general partner. Section one explains how the PE industry has defended itself with a legitimising narrative about the social benefits of general partner ownership with control, as against the public company form whose passive owners are remote and ineffectual. Section two challenges this representation by presenting a short history of the limits of the predatory conglomerate form and explains the logic of PE’s undisclosed business model which increases the role and reward of the active financier. The generic business model is to construct a hierarchy of claimants with different rights of ownership and thereby hard wire cash distribution in favour of the general partner. A third section presents empirics on distributive flows so as to show how the hierarchy of ownership rights works reliably to enrich the PE general partner regardless of fund performance; and at

the same time generates sufficient return for the pension funds whose investment as limited partners creates the fund which the general partner controls. Section four explains how the fixed ownership forms of PE enable mobile opportunism. It presents evidence on how PE has negotiated conjunctural change since the credit crunch in 2007 as it shifts tactically from issuing debt in a period of excess liquidity to purchasing assets including debt from distressed sellers. A concluding section reflects on the implications of our analysis of present day financialized capitalism. If capitalist hierarchy is now secured partly through a political division of ownership as well as a political division of labour, this requires a new policy response focused on the control of ownership position (not identity).

2. Ownership with control: better ownership and the legitimising narrative about PE

In the inter-war period, authors like Tawney (1921) and Keynes (1936) were sharply critical of some types of owner such as coal mine owners or rentier shareholders. But this distinction between good and bad ownership vanished as the neoliberal revolution in the Anglo-Saxon world endorsed (more) ownership. If we look back at the UK and US since the election of the Thatcher and Reagan governments in 1979 and 1981, an ideology of popular capitalism has been built upon promises about what more private ownership and better forms of private ownership could deliver. Whether we consider utility privatisation or housing policy, the promise was that the extension of private ownership and competitive markets would deliver economic and social benefits. Hence US sub-prime lending to new classes of home owners was always before 2007 represented positively as a ‘democratisation of finance’ (OECD, 2004). In instances where ownership disappointed, the reforming impulse was always to demand better ownership. Hence UK corporate governance reforms in the 1990s responded to indignation about ‘fat cats’ and rewards for failure by introducing proceduralised governance which aimed to restrict management by empowering investors (Cadbury 1992; Greenbury 1995 and Hampel 1998). The PE industry then benefited greatly from ongoing concerns about what governance could achieve in resolving agency problems in public firms whose shareholder owners were dispersed and passive.

PE in the 2000s was able to play off these concerns and use the tropes of governance to present PE as a better organisational form because the general partner as active owner reduced what authors like Jensen and Meckling (1976) or Fama and Jensen (1983) would call ‘agency costs’. Such representations became politically important in 2007 as Trade Union campaigns and media scare stories raised questions about the social responsibility of PE and the rewards of general partners (Montgomerie et al, 2008). In response PE trade associations and firms used their ownership narrative to defend PE on the grounds that PE general partners as active owners closely supervised managers in portfolio companies thereby delivering benefits to the pension funds who invested as limited partners in PE funds. Interestingly, the PE trade’s arguments about ownership were not dismissed as special pleading by a trade lobby but instead were repeated and endorsed in a variety of official reports and submissions. The ‘better ownership’ line was even echoed in a formal report on PE by the Financial Services Authority, which insisted that, ‘the control that private equity fund managers exercise as owners of the companies they invest in is what truly defines the private equity business model’ (2006: 45) arguing that, ‘fund managers can add real value by bringing their expertise and insight to a firm’ (2006: 45).

The PE industry sponsored Walker report on private equity contrasted the ‘attenuation and impairment of the agency relation between owner and manager in the public company’ (Walker, 2007: 14) with PE’s better way of organising ownership with control:

‘... alignment is achieved in PE through control exercised by the general partner over the appointment of the executive and in setting and overseeing implementation of the

strategy of a portfolio company. Lines of communication are short and direct, with effectively no layers to insulate or dilute conductivity between the GP and the portfolio company exec team..... This direct alignment between shareholder and executive minimises and may substantially eliminate agency tension in private equity'

(Walker, 2007: 23)

Much the same argument figured in establishment submissions by the Bank of England and the Chartered Accountants of the ICAEW, to the Treasury Select Committee inquiry into PE:

The chain of ownership and communication is relatively short, giving the owners of capital much clearer direction of the businesses which they are financing than under some other forms of ownership.

(HM Treasury evidence, cited in Treasury Select Committee report vol.1: 12)

...a publicly listed company with a diffuse shareholder base needs to address potential agency conflicts through adherence to corporate governance norms and will invest significant time and money in communicating with shareholders, investor relations and periodic reporting. By contrast, management of a PE backed company has more opportunity to focus on strategy.

(ICAEW evidence cited in Treasury Select Committee report vol. 1: 12)

Thus the benefits of PE's ownership with control became established as doxa through cut and paste repetition of the same few assertions about direct control, short chains and incentives for managers. The PE industry egged the pudding by emphasising that these ownership benefits accrued to pension funds who were the main investors in PE funds thereby creating the impression their higher social mission was to help pensioners as limited partners. Throughout 2007, PE representatives made an explicit connection between PE performance and the retirement income of ordinary pensioners, as in the quote below from the UK trade association chair:

The ultimate beneficiaries of private equity are pensioners and people who benefit from pension funds that invest in private equity.....it's ordinary working people who are the ultimate beneficiaries of private equity

(Wol Kolade, BVCA chairman, Radio 5 Live, 9 October 2007)

Most of this was apparently so self-evident that it could be asserted without regard for empirics and without rehearsing tedious or inconvenient detail about the record of returns for external PE investors, usually pension funds. The trade sponsored Walker consultation document claimed without sources or evidence that risk adjusted rates of return were, 'typically but not invariably' in excess of those in listed markets (Walker 2007: 12). The more sceptical Treasury Select Committee report did survey available evidence and concluded less comfortably that, 'evidence on the returns achieved by PE is mixed' (Treasury Select Committee 2007: 9).

Academic research on returns for external (limited partner) investors in PE funds is fairly summarised in that Treasury Select Committee verdict. If the evidence does not support the 'better ownership' argument, there is room for disagreement because interpretation is complicated by measurement issues, reporting bias and problems about adjusting for risk (Groh and Gottschalg, 2008). If these authors find alpha, further complexity is added by the variability of PE's historic performance which reflects a changing activity mix of companies by size and sector bought at different times over the asset and credit cycle. However, on balance and with provisos, academic surveys of returns to external investors do not generally

show that investments by PE limited partners deliver consistently higher returns than public equity investments in ordinary shares (e.g. Wood and Wright, 2007). Indeed some long run studies report lower limited partner returns on PE investment than in public equity after management fees have been deducted (e.g. Kaplan and Schoar, 2005; Phalippou and Gottschalg, 2008). Maybe more important in the context of claims about a better form of ownership, PE fund returns are also highly variable in cross section. Exhibit 1 below illustrates the point by considering the historical record of returns on PE at CalPERS in the 1990s where all the return comes from the top 60% of fund investments.

Exhibit 1: Variation of returns on CalPERS investments in private equity

	<i>Quintile 1</i>	<i>Quintile 2</i>	<i>Quintile 3</i>	<i>Quintile 4</i>	<i>Quintile 5</i>	<i>Total/ Average</i>
Cash invested (\$mill)	\$1,069	\$1,736	\$1,290	\$1,346	\$1,000	\$6,441
Cash return plus remaining investment (\$mill)	\$606	\$1,927	\$2,001	\$2,630	\$2,704	\$9,868
Multiple return on original investment	0.57	1.11	1.55	1.95	2.70	1.53
No. of funds raised	18	18	19	19	18	92

Source: <http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/equities/aim/private-equity-review/aim-perform-review/home.xml> (Accessed 25th April 2007)

Note 1: Data relates to vintage investments where the cycle of returns is complete.

Note 2: The funds are ranked by the multiple of the return on original investment and then split into quintile groups. The multiple refers to the return on original investment.

Thus, the mixed evidence on financial returns for PE limited partners simply does not fit with the strong assertions and assumptions made in the legitimising narrative about the general benefits of ownership with control. Either PE is not about ownership with control, or the benefits of ownership with control are more modest and variable than they appear to be in the trade narrative. If the next question is how else we might think about PE, we might start by taking a descriptive turn.

3. Control of ownership: PE's business model and its pre history

Near the beginning of most official reports on PE, readers will usually find some descriptive background on how PE organises its trade of buying and selling companies. From this, readers will find that some 200 PE management companies in the UK were, by the mid 2000s, raising PE funds with finite lives of 10 years which buy existing companies (not start ups) and then sell on after 3-5 year holding periods. The management companies are usually unquoted and the funds are organised as separate limited partnerships with two classes of partner: the managing financiers are general partners (GPs) who contribute a sliver of around 2% of the equity fund with the remaining 98% contributed by outside investors, the limited partners (LPs). These outside investors are typically pension or endowment funds, and a medium or large fund will typically have some 150 limited partners. The general partner is rewarded with an annual management fee of 2% on funds invested and a performance fee of 20% of profit

which is generally paid after a hurdle rate of return, usually around 8%, has been achieved (Wylie, 2007). There is some evidence of limited variation on standard practice and the Treasury Select Committee claimed that the standard management fee on larger funds had fallen to between 1.5% and 1.75% of total funds managed (Treasury Select Committee report, vol. 1: 34). Before the credit crunch of 2007, the equity fund's purchasing power was levered up by issuing debt to cover most of the cost of buying companies under a standard purchase formula which was typically 70% debt and 30% equity (Froud and Williams, 2008). The debt was then subsequently sliced and diced into various senior, subordinated and mezzanine tranches with higher rates of interest for the weaker claims. This debt was initially placed with banks who then sold on the loans under the 'originate and distribute' system which prevailed prior to the 2007 credit crunch.

The distribution and investment ratios of '2 and 20' and '70-30' are widely reported but the question of who sets (and benefits from) the ratios is seldom analysed and the partnership form is often ignored. The Treasury Select Committee report for example, does not analyse the partnership form. Against this, we would argue that these arrangements define PE's business model, which is about organising a hierarchy of ownership rights and claims. This perception requires us to extend our ideas about what constitutes a business model. In previous analysis of giant private and public firms we have defined the business model generically as a corporate manager's discretionary plan for recovering costs from operations and securing financial viability within a given institutional and organisational frame, where stakeholder expectations must be met (Froud et al, 2008). In this sense, the business model is how General Electric delivers shareholder value or how the BBC satisfies newly empowered multiple stakeholders. With PE we have a rather different kind of business model as the financier's standardised plan for redistributing cash from dealing and operating through setting up a new organisational frame which creates a hierarchy of ownership claims. The result is that managing general partners earn a large reward regardless of performance and subaltern limited partners are also rewarded sufficiently to ensure their commitment to the PE model. In this section we analyse the logic of the design and in the next section consider what it delivers empirically.

In historical context, we can understand the PE business model use of partnership and debt as an American innovation which became significant in the US leveraged buyout (LBO) boom of the 1980s and was subsequently adopted in the UK and elsewhere. PE provides an interim historical solution to earlier problems about using public companies as the vehicle for trading assets through buying and selling companies. These problems have nothing to do with the generic problems of governing the public company in the shareholder interest, but everything to do with the specific problems of the acquisitive financier in the predatory conglomerate who finds that in a public company his/her share of the rewards is limited if he/she plays the game of trading assets with shareholders' money.

The 1975 collapse of Slater Walker in the UK discredited pure asset trading operations which are inherently fragile because they depend on continuous, successful deal flow. However by the mid-1980s a new generation of publicly listed predatory conglomerates like the Hanson Trust had moved the game on as they combined aggressive dealing with a reassuring commitment to operating cash generative businesses. Hanson therefore presented itself as a 'good manager' of business operations and was praised as such in academic texts and the business press (e.g. Gould and Campbell, 1987). But, Hanson's dependence on dealing was alleged by its critics at the time and subsequently admitted in the obituaries for James Hanson (e.g. Financial Times, 3 November 2004). More than half of Hanson's income in the 1980s came from breaking up companies and selling on divisions at prices which left it with free operating businesses whose cash generation was levered through arbitrage on interest rates and avoidance of corporation tax (Adcroft et al, 1991: 5-10). Yet upside gains on the dealing activity for the two principals James Hanson and Gordon White were capped by the public company status of the firm which ensured that most of the gain went to ordinary shareholders

who owned the firm. Worse still, without any provision for cashing out and closing the book on their trades, the two principals (James Hanson and Gordon White) had to do ever bigger deals to maintain a high share price because that was their currency for further acquisitions.

The new organisation of PE, developed and tested in the USA in the LBO boom of the late 1980s, resolved each one of the financier's problems with the public company. PE offers a finite life vehicle of 8-10 years (and thus an exit strategy), offers discretion about the pursuit of bigger deals, plus the control of ownership claims through the creation of different and unequal classes of capital provider below the general partner which ensures the diversion of cash to the financier principal as general partner. The diversion of cash is crucial because PE organises trading in companies on a cash in and cash out business: LP equity investors normally receive cash back from an initial cash investment in a fund that includes managing GPs as (notionally at least) cash investors and are certainly rewarded in cash not coupons. This sets a fundamental upper limit or constraint on total rewards for all owners because it is much harder to fabricate cash than profit. But the consolation is that cash flows easily under everyday conditions of liquidity and fungibility, so that it can be easily diverted into channels which differentially benefit various groups of owners. Hence the PE business model uses ownership rights to distribute cash and rights of control between three different groups or parties: general partners, limited partners and debt providers. If we then focus on the standard PE business model, it combines three standardised ownership related mechanisms which advantage the general partner: first, leverage with use of debt to improve equity returns for general and limited partners; second, a contractually agreed fee structure which privileges general partner equity holders; and third, terms of ownership which significantly disfranchise all outside providers of debt and equity.

Before turning to describe the logic of these mechanisms, we would note that the cash nature of the business model also encourages secondary strategies of tax avoidance. A pound of cash saved through tax avoidance is just as good as any other pound, so the ratio of net to gross receipts is improved by a kind of institutionalised arbitrage around tax regulations and regimes. Corporate debt has long had preferential tax treatment because interest payments are deducted before tax is levied and the unintended effect is to make leveraged buy outs highly tax efficient. The effective rates of tax on business income are then further reduced by the creation of chains of corporate entities so that the operating businesses remit cash to offshore tax havens (see European Commission 2006 for discussion). The other important issue is the rate of tax which the individual financier, general partner pays on cash drawn down. The basic concession here is that the performance fee, or the 'carry' of 20% of profits, is not treated as income for deal making on the 98% of funds contributed by limited partners, but as a capital gain on the general partner's investment of just 2% of the fund. After lobbying in the UK, the carry was subject to the low taper relief tax rate of 10% and the minimum holding period was reduced to just two years by 2002 (Treasury Select Committee, vol. 1: 42). Those general partners who can claim 'non-domiciled status' by virtue of foreign origins or connection can also avoid all UK tax on non-UK earnings, which was another materially important concession when the PE workforce was cosmopolitan and more than half of their investments in the early 2000s were being made in mainland Europe.

Tax avoidance by PE general partners keeps many lawyers and accountants employed, but it only improves on a basic distribution of cash enshrined in ownership related mechanisms. The first of these mechanisms is leverage with 70% of the cost of purchasing portfolio companies met by raising debt. When companies are bought with 70% debt and 30% equity, leverage automatically improves the returns to equity providers as long as debt is cheaper than equity. Furthermore, the returns to debt holders are usefully capped because the holders of debt have a fixed entitlement which in the 2000s averages out across different classes of debt at approximately 3.75-4% above LIBOR. This average rate can be calculated from published information on deals like the Yell purchase and trade contacts confirm that this was the going

rate on mid 2000s buyouts. Thus, if dealing produced returns much higher than 8% or so in the mid 2000s, those returns were largely distributed to equity providers.

If debt therefore benefits all holders of equity ownership rights, the second ownership mechanism is to create different and unequal classes of equity holders in PE. The two classes of equity investors, general partners and limited partners are effectively senior and subordinate equity providers respectively, because one draws and the other pays fees (via charges on the fund) and the fee structure guarantees large cash distributions to the general partner with or without high performance for the limited partners. The 2% management fee is designed to provide failsafe income for GPs without any performance conditions and introduces a scalar element that automatically increases rewards those who raise larger funds. From this point of view, it is ironic that general partners claim to solve the governance problems of PLCs because general partners of larger funds earn more regardless of performance, just like CEOs of large failing companies. The 20% 'carry' profit share then becomes the success fee for performance which offers the possibility of a jackpot win in return for 2% of initial equity stake. This element of ownership design ensures the general partners get a much larger multiplicand on their original investment if a large fund succeeds. Overall, the general partner's 2% cash in and 20% cash out is a bit like the casino setting the odds in its favour; and this sets up the general partners, like a casino manager, to offer games where they have an advantage over ordinary players.

If design for distributive advantage is achieved through the differentiation of ownership claims, the direct control of ownership rights is also important. At this point, we should recognize that PE's use of the terms equity and debt is confusing because limited partner equity and mezzanine debt come with many fewer rights for outside investors and mean something very different from equity and debt in a public company. The disfranchisement of limited partner equity investors and debt providers is a third important ownership mechanism which works to the advantage of general partners. Without the traditional equity rights of exit and voice, the limited partner equity holder is contractually subordinated to the senior equity of the general partners. The limited partner equity holder does not have the public equity right to exit by selling the share and so is effectively locked in because any new investor would need to do due diligence on the underlying assets (Walker, 2007: 12; Financial Services Authority, 2006: 25). The limited partner equity holder also gains the protection of limited liability by renouncing rights to operating control. Thus, LPs can form an advisory committee, but not a public company style board involved in day to day management and strategy (Walker 2007: 28) and have little or no opportunities to replace GPs (Lerner and Gompers, 2005: 67).

As for PE debt holders by the mid 2000s they typically had much less of the traditional recourse protection which public company debtors enjoy because they can take over the company as soon as covenants are breached. In a period of excess liquidity, derivatives and small premia for risk, the logic of tranching was that mezzanine with fewer covenant protections expanded at the expense of senior debt with traditional protections. So that, as the FSA (2006: 33) noted, Europe was by the mid 2000s moving closer to the American model where senior debt accounted for only a few percent of total capital. This was then reinforced around 2005 by the rapid development of PIK or payment in kind loans where the borrower can pay with more paper; and by 'cov lite' loans where breach of covenant would only be tested in specific circumstances as when the company proposes to issue more debt. The disfranchisement of PE debt was only possible because of bankers operating "originate and distribute" models in a period of excess liquidity; but the result was to serve the purpose of increasing the power of the GP. As Peter Linthwaite of the BVCA admitted to the TSC (Treasury Select Committee, 2007: 24) disfranchisement of debt holders effectively postpones the point at which the banks take over and equity is wiped out when things go wrong (and we would add does so without imposing any conditions about sale of assets by controlling GPs in

the period before the debtors take over). All this makes debt much more like risk capital and incidentally undermines the traditional rationale for debt being cheaper than equity.

More generally, the disfranchisement of equity and debt is a serious issue because, as we have noted, many general partner managed PE funds deliver poor returns for limited partners and, in cyclical activities like retail, levered portfolio businesses are inherently much riskier in any downturn. In the legitimising trade narrative, PE solves the public company governance problem of ownership without control because the general partner is an active owner; after considering the mechanisms for controlling ownership maybe PE does not so much solve the governance problem but instead moves it to another place because the financier general partner is more of an absolute monarch than any public company chief executive could ever be. This is disquieting when the arrogance of the deal making financier is a recurrent historical motif. Older readers will remember media stories and shareholder unrest about how Gordon White of Hanson Trust charged his race horses to the company; with PE, the public would never know and limited partners could do little about it.

4. Empirical evidence on distributive flows: how the business model delivers

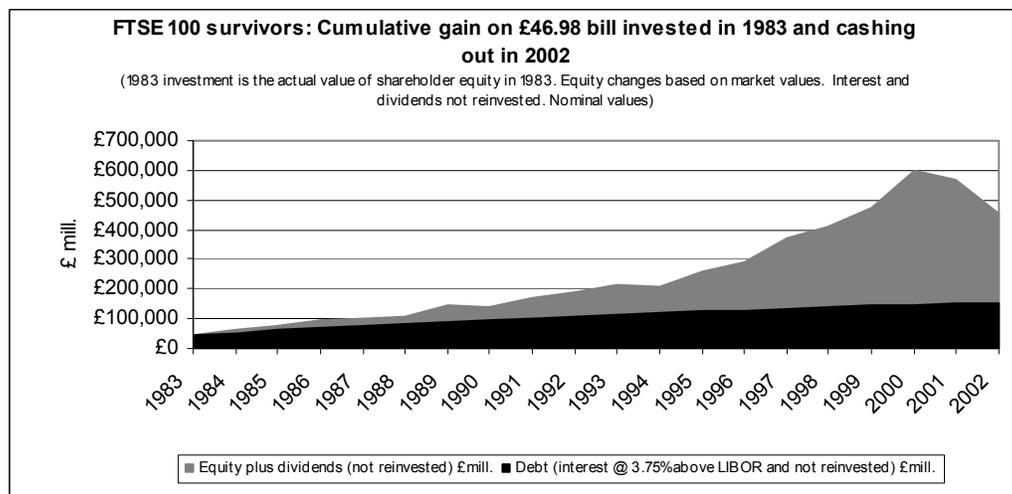
In its public discourse the BVCA trade association ‘paints out’ the enrichment of general partners by emphasising the returns they generate for their pension fund limited partners. In its own terms, British PE’s ‘for the pensioners’ alibi glosses over the point that UK pension funds in 2006 held less than 1.5% of total assets in PE (Citigroup, 2006: 4); insofar as most of the funding comes from US institutions and is invested in Europe, City of London based PE is running a kind of *entrepot* trade in money. If we start instead from the design of the business model, we can pose and answer two interesting empirical questions about whether and how the general partner’s control of ownership rights delivers what it promises by reliably diverting cash under different circumstances. First, are the returns for limited partners sufficient to secure a continuing inflow of funds into PE from the limited partners who provide 98% of the equity into the fund, without which there is no activity? Second, do the ownership rights of general partners reliably generate high cash rewards and limit risks so that PE general partners are enriched in a variety of circumstances, including fund underperformance or unexpected economic downturn? These questions can only be answered using mixed methods from fragments of information, but the answers suggest that leverage through 70/30 can generate enough to satisfy the limited partners while fee structure through 2 and 20 ensures general partner enrichment through high returns with low risk.

On returns for limited partners we can make several points. The inflow depends not on the actual return but on the limited partner’s *expectation* of equity returns from PE fund investment greater than the mediocre long term returns from traditional long only equity investment. This condition was clearly met before 2007 as new funds were generally oversubscribed and the post 2007 difficulties of PE have been about selling debt on larger deals not raising new equity funds. But the limited partner expectation is shaped by experience of achieved returns and here 70% debt and 30% equity leverage is crucial because, from the mid 1990s until 2007, debt capped returns to the majority of capital providers at a modest rate and thereby boosted returns to all equity holders. Under these conditions of cheap debt, the necessary and sufficient minimum condition for higher returns on PE equity capital through leverage is simply that the companies purchased should be low geared and cash generative (with rising asset prices as a bonus and cyclical downturns as the major risk). Counterfactual empirical work suggests that this condition is easily satisfied in public companies. The Treasury Select Committee Report (2007: 23) reprinted our own work on the FTSE 100 which has historically run with 70% equity and 30% debt; if this ratio is inverted to 30% equity and 70% debt at 3.75 % over LIBOR, then equity returns are higher in most years. A Citigroup study in 2006 mimicked the PE investment style with counterfactual levered purchase of cash generative, low debt mid-caps from the Pan-European DJ Stoxx. Citigroup

added debt and then tracked its sample which *under PLC management and with leverage* then generated higher equity returns than PE so that the conclusion was ‘it is not difficult to generate superior returns from the public equity market’ (Citigroup, 2006: 8).

Of course in a broad social sense the strategy of substituting low return debt for higher return equity it is all about robbing debtor Peter to pay equity holder Paul because the gains of one group of investors are at the expense of others. If the process is extended, the end result would be that the majority of investors in corporations would be bond holders excluded from the upside gains from dividends and share price appreciation which were previously spread widely through ordinary shares. This can be demonstrated by a thought experiment on the FTSE 100 in the golden stock market years of the 1980s and 1990s (exhibit 2). If we consider the FTSE survivors who were in the index in 1983 and in 2002, their equity was worth £47 billion in 1983 and share prices had appreciated so that twenty years later by 2002 the shareholders had a capital gain of £391 billion on their equity holdings which had meanwhile paid out £167 billion in dividends so that the cumulative gain (without reinvestment of dividends) was £558 billion. If the £47 billion of equity had been converted into bonds which paid 3.75% above LIBOR, there would have been no capital gain on the bonds and interest payments of just £108 billion.

Exhibit 2: Gains from equity investment and simulated substitution of debt in FTSE 100 survivors, 1983-2002



Source: *Derived from Datastream*

Note: FTSE Survivors are the group of firms that have remained continuously in the FTSE 100 index since 1983

From this point of view, the use of debt by PE represents a kind of banal privatisation of the old liberal collectivist social imagination. We can recall that the PE practice of substituting cheaper debt for equity is a reprise of Keynes (1936: 374-7) *General Theory* proposals for the euthanasia of the rentier under which low interest coupons (like bonds) would be substituted for shares. Keynes made his proposals with two broad social aims: to stabilise the macro economy and reduce unemployment created indirectly by fluctuating shareholder expectations; and to encourage more investment to defeat ‘the dark forces of ignorance’ and increase society’s production possibilities. Compare and contrast PEs use of cheap debt which is for the private advantage of the minority of equity providers amongst whom some partners are more equal than others under ‘2 and 20’ payment structures.

From this point of view, the remaining empirical question is whether and how PE's hierarchy of claims works reliably to enrich general partners. To begin with, the 2% fee on committed capital introduces a kind of failsafe claim which ensures enrichment of the general partner more or less regardless of fund performance. Metrick and Yasuda's (2007) study found that US buy out fund GPs can make twice as much from flat fees as they can from the 20% performance related carry. The logic of the fee structure is that the flat 2% fee makes raising bigger funds attractive because bigger funds are more lucrative regardless of performance. This point emerges from the UK management accounts for some typically successful British PE funds, which we obtained in 2006 on the basis that we could publish anonymised figures. As exhibit 3 shows, the 2% fee alone on a large fund brings in £16-32 million per partner over 5 years whereas the 2% plus 20% fees on a successful mid-market fund brings in £9-20 million. Of course, the management fee on most large funds would be closer to 1.5% and the sum generated is not all net income because expenses need to be deducted although it should be noted that expenses are reduced by charging much of the cost of buying and selling to the operating companies. But, 2% in larger funds serves its primary aim of enrichment without performance conditions because it ensures general partners in large funds can walk away with £5-10 million regardless of the returns generated for limited partners. There is nothing new about elites being paid regardless of performance because CEO pay is effectively scaled according to the size of company (Froud et al, 2008), but PE general partners can much more easily raise larger funds than most CEOs can grow the company by merger.

Exhibit 3: Fees earned over 5 years on successful mid market and large PE funds

	<i>Mid-market fund</i>	<i>Large fund</i>
Funds under management	£250-£500 million	£4-£8 billion
Management fees: 2% of committed capital over 5 years	£25-£50 million (£4-£5 million per partner)	£400-£800 million (£16-£32 million per partner)
Number of full general partners and their share of the carried interest ('Carry')	6-10 partners share 100% of the carry	20-30 partners share 75% of the carry
Carry over 5 years available to general partners. Based on carry as 20% of fund profits	£40-£120 million (£5-£15 million per partner)	£625-£1,250 million (£25-£50 million per partner)

Source: Anonymised management accounts.

Note 1: Returns over 5 years on funds which are still operating

Note 2: Figures converted into ranges so that source cannot be identified

Note 3: Representativeness was confirmed by an experienced observer

The 'carry' and the 20% profit share appear to be much more defensible because this is a conditional claim which depends on performance. Certainly, the GPs 20% of all profits (after a hurdle rate of 8 or 10% has been achieved) is the mechanism that generates jackpot multi-million rewards for GPs on any moderately successful fund. But here again size matters because the fee earned depends on the rate of return and the lump of profit. As exhibit 3 shows, depending on the number of partners, a 20% carry in a successful mid-market fund earns £5-£15 million per partner over 5 years whereas the same 20% on a large fund generates £25-£50 million per partner. The logic of 20% of profits regardless of fund size is that a general partner's carry in a moderately profitable large fund can be more lucrative than a

highly profitable smaller fund. Whatever the size of the fund, once the hurdle rate has been achieved, the contractual disproportion between initial investment and share of profit (2% share of equity input and 20% of profits) ensures that the general partner always gets a much higher return on initial investment than the LP. This can be illustrated by considering individual deals on companies where the relevant information is available from publicly available sources like initial public offering documents. Exhibit 4 presents the results for Yell, the classified directory business which was acquired from British Telecom by Hicks, Muse, Tate & Furst and Apax Partners in May 2001 for £2.14bn (Financial Times, 30 May 2001) and floated at a handsome profit of £1.4bn just over two years later (Financial Times, 7 Jan 2004). If we reconstruct the Yell deal for equity holders on standard industry terms, then the general partners put in 2% of equity and drew 20% of profit when the public offering was made so that the general partners earned 15.6 times their initial stake while the limited partners did no more than double their stake.

Exhibit 4: General partner and limited partner returns on Yell 2001-2003
Yell acquired on 22nd June 2001 and IPO on 3rd July 2003 (25 months)

		Limited partners (98% investment) £ million	General partners (2% investment) £ million
Outlay	Equity investment (2001)	592.7	12.1
Income	IPO share (2003)	1,269.5	200.4
Net extraction		676.8	188.3
Multiple gain on outlay		2.1	15.6

Source: *Report and accounts and IPO document.*

Note 1: Gains exclude post-IPO shares held by the partners and debt still invested in Yell.

Note 2: While Yell remained under private equity ownership the company made pre-tax losses.

But, when all these qualifications have been entered, the key question remains whether the jackpot rewards via the ‘carry’ represent a justifiable success fee for general partners? The issues here are related to those which arise in considering corporate CEO pay where defenders and critics of high pay have to determine the proportion of the reward due to either management effort and/or to external circumstance. We would generally expect a weaker connection between effort and reward in the case of the PE general partner because, as we have already noted, leverage can financially engineer higher returns on equity and PE is also about dealing in companies as well as operating so general partners can make windfall losses or gains on holding the company. Windfall was important in the period from 2002 to 2007 which was one of asset price rises, multiple uplift on resale to the stock market and interest rate falls which allowed PE GPs the freedom to recapitalise their firms with cheaper debt which allowed special dividends.

PE industry representatives have always used the language of growth and construction. For example in an interview with the Mail on Sunday, BVCA chairman Wol Kolade argued, ‘we make money from building and growing the companies we own. We make money from creating value’ (Mail on Sunday, 23 September 2007). More specifically the argument is that PE funds which buy and hold portfolio companies cannot make money from corporate failure (unlike a hedge fund shorting the shares of a failing company). This position would be justified if selling the company on for cash is the only way whereby general partners can add

value. But that condition is not met when PE has other ways of extracting value through recapitalisation and special dividends, through asset sales such as property sale and leaseback, or through the sale of some businesses which are part of larger operations. If these options are open to GPs, it is perfectly possible for PE investors to recover their equity stakes and realise a large profit before the corporate vehicle crashes. This point can be illustrated by considering Focus DIY (exhibit 5) where general partner cash extraction realised large returns on investment but left a debt-burdened company to fail as other stakeholders picked up the tab.

Exhibit 5: Duke Street Partners extractions from Focus DIY
Duke Street Partners acquired Focus DIY in 1998 and Cerberus acquired it in 2007 for £1.

		Limited partners (97.5% investment) £ million	General partners (2.5% investment) £ million
Outlay	Equity investment	331.5	8.5
Income	Refinance (2003)	331.5	8.5
Net extraction		288.4	80.8
Multiple gain on outlay		1.9	9.5

Source: *Report and accounts and IPO document.*

Note 1: While under Duke Street ownership, Focus DIY acquired other DIY companies: Do It All in 1998 for £68mill, Wickes in 2000 for £290mill and Great Mills in 2000/01 for £285mill.

Note 2: In 2002 Apax acquired a 28.9% holding in Focus DIY and during 2003 Duke Street Partners refinanced the enlarged company. In 2004, Wickes was sold to Travis Perkins for £950mill.

Note 3: In 2007, Focus was sold to Cerberus for £1.

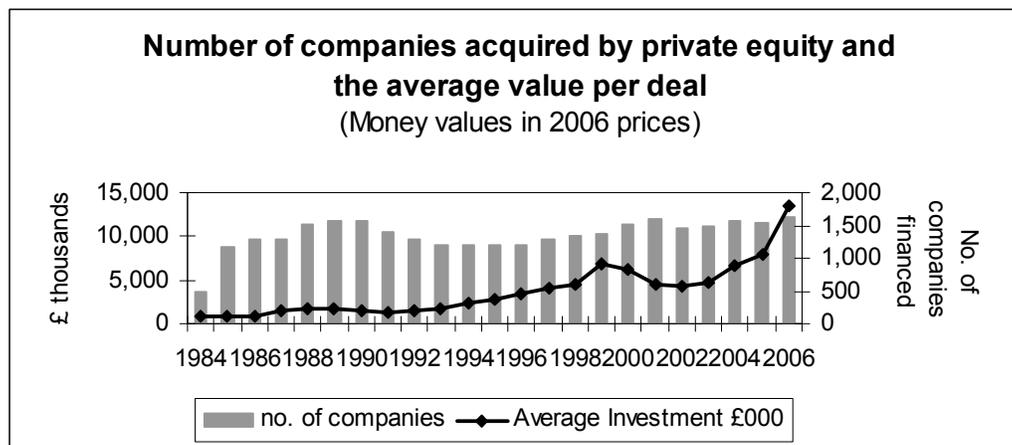
In 1996 Duke Street Capital bought 45% of Focus DIY (The Times, 20 August 1998). Subsequent acquisitions of *Do It All*, *Wickes* and *Great Mills* made Focus DIY by 2002 the second largest DIY group in the UK with 430 stores (Financial Times, 29 November 2002) and a debt burden of £650m (The Times, 30 November 2002). The sale of 28.9% of the business for £340m to another private equity group, Apax Partners in November 2002 allowed Duke Street to recover all of its original equity input through a special dividend (The Times, 30 November 2002). The sale of Wickes in 2003 for £950m then netted the equity providers a large dealing profit of £369.2m so that the Limited Partners virtually doubled their initial investment, while the General Partners realised a 950% gain (Exhibit 5). When Wickes was sold, the cash extraction was such that the remaining Focus business was left burdened with so much debt that it could not survive a minor downturn in DIY sales. After credit downgrades (Moody's Investors Service, 22 February 2005; Reuters, 5 March 2007) Focus finally breached its loan covenants in June 2007, and was then sold to US hedge fund Cerberus for just £1 (Financial Times, 19 June 2007). The final loss of equity was of no great significance for the general partners and their limited partners because the equity loss of 2007 was much smaller than the gains from refinancing and restructuring during 2003-04. Other stakeholders were more unfortunate. Senior debtholders were repaid in full, however those holding mezzanine notes received only 40p in the pound for their debt. Duke Street also left Focus pension funds with a deficit which they were forced to top up with £8m after intervention by the pensions regulator (Financial Times, 2 September 2008).

5. Fixed ownership and mobile opportunism: PE negotiates conjunctural change

The above examples demonstrate how PE general partners stand to benefit from the political division of ownership rights, which award them the power to extract cash and generate returns, with mixed results for other stakeholders. But all our examples of general partner value crystallisation and extraction are taken from the previous favourable conjuncture from 2002-07 before the credit crunch of 2007 and the financial crisis of 2008 blocked the issuing of debt for purchase and the easy sale of portfolio companies. Now PE must opportunistically reinvent as old sources of gain are blocked in a new conjuncture where the division of ownership nevertheless remains a source of advantage.

The period from 2002-07 was one of upscaling for PE with larger funds and bigger deals. Global PE deal volumes increased from \$113bn to \$488bn (Citigroup, 2006) and the number of buy out funds raising more than \$1billion increased from 9 funds in 2002 to 51 funds in 2007. As exhibit 6 shows, British PE continued along its established trajectory of buying 1,500 (larger) companies every year with size of average investment trebling to £13.4 million between 2002 and 2007. As Guy Hands of Terra Firma put it, 'PE firms were incentivised to earn as much as possible, as quickly as possible, and raise as much as possible and to spend it as quickly as possible' (Financial Times, 24 September. 2008). This was a response to new conjunctural opportunities arising from the end of the 1990s bull market which leads to disappointment with PLC Shareholder Value and long only equity strategies which lost money between 2000 and 2002. Meanwhile, in a policy response to the tech stock crash, Greenspan cut US interest rates to 1% so debt was cheap in a period of excess liquidity which forced up asset prices and in doing so validated earlier punts. The result was hockey stick growth for PE as well for hedge funds which used leverage to increase gains, introducing, a point rather than stream concept of value as value was crystallised by selling the coupon or company on the old trading principle of cashing out when ahead.

Exhibit 6: Private Equity average equity investment and number of companies financed, 1984-2007



Sources: http://www.bvca.co.uk/publications/publications/ria_2006_summary_results.pdf and <http://www.bvca.co.uk/> (Report on Investment Activity)

Notes: Data includes adjustments for 3i investments. Consequently, 1985/86 totals may not summate to geographic breakdown. The data refers to equity (or similar) investment

But when the credit markets closed in summer 2007 and asset prices started to fall, the old game of upscaling funds to buy ever bigger companies with aggressive leverage and rapid

deal turnover was over (Bernard, 2007) even if mid cap deals were still being done (Financial Times, 10 July 2008). As recession bites, some PE owned companies will fail but the consequences for PE funds will be moderated by cov-lite loans and PIK bonds which give them the opportunity to extract cash first and pay down debt with paper: out of 43 bond deals done with a PIK feature, at least 8 borrowers had already suspended cash payments and were paying in bonds in summer 2008 (Financial Times, 3 June 2008). But PE is also awash with money to invest because large sums were raised but not invested before the credit crunch. The industry source Private Equity Intelligence reports that after record capital raisings in 2006 and 2007, private equity globally has \$450 billion of cash (Wall Street Journal, 5-7 September 2007). While new funds are still being raised so that the \$85.5 billion raised in the first half of 2008 is not hugely behind the record \$108 billion raised in the first half of 2007 (Wall Street Journal, 5-7 September 2007).

So what is PE buying in the new conjuncture or, more exactly, in the interregnum between conjunctures? Just as they led on upscaling in the old conjuncture, the large US PE firms are currently at the leading edge of reinvention in anew game of trading paper where PE is more likely to be buying debt than issuing it (Financial Times, 11 August 2008).

- (1) PE is buying minority stakes in public companies, as when the Texas Pacific Group took a 23% stake in Bradford and Bingley (Financial Times, 9 June 2008). The stakes in banks are always minority ones because PE groups cannot hold majority stakes in banks without being regulated as bank holding companies.
- (2) PE is buying back its own transaction debt from banks which failed to distribute it before the credit crunch. The banks were stuck with between \$100 and \$300 billion of unsaleable PE loans, which were risky and often cov-lite. PE firms are now prepared to buy if the loans are discounted and often leveraged with funds provided by banks which are eager to get the transaction related debt off their balance sheets. Citigroup led the way by selling a \$12 billion package of leveraged loans to a consortium including Apollo, Blackstone and TPG (Global Investor, 1 June 2008) and Deutsche bank followed with similar sales of US and European buy out debt (Financial Times, 24 April 2008).
- (3) PE is buying portfolios of debt paper and assets like property which the banks as distressed sellers have to get off their balance sheets. In the most spectacular of these deals Lone Star bought collateralised debt obligations (CDOs) with a gross value of \$30.6 billion from Merrill Lynch which provided three quarters of the purchase price funding secured only against the CDOs themselves. Thus, Lone Star were buying the upside on ownership for around 5 cents on the dollar of nominal value, which also represented the limits of its losses on the downside (Financial Times, 1 August 2008). Meanwhile, Blackstone has bought GSO Capital Partners to gain the expertise of this debt boutique while Apollo has worked out its own version of the GSO strategy of, 'buying up non-distressed debt from distressed sellers' and steering clear of problem sectors like car parts and airlines (Financial Times, 11 August 2008).

These developments are interesting because the new purchases by PE are completely inconsistent with the trade's earlier legitimating narrative about ownership with control. When PE buys minority stakes, below par debt and cheap assets, it does not have control of what it buys and the strategy is transparently about buying and selling paper at the right price not direct management of operations in the holding period. Several key PE figures are honest about how the shift in the price of debt had turned them from issuers of debt to investors in debt: Jim Coulter co-founder of Texas Pacific Group said, 'We borrowed when we knew that debt was too cheap. Now that debt is more expensive (to issue), it is a good time to invest in debt' (Financial Times, 11 August 2008). Fund raising for PE funds to buy distressed debt is at record levels in 2008 when by mid year \$32.8 billion already had been raised and a further

\$21.4 billion was being sought (Private Equity Intelligence, cited Financial Times, 13 August 2008).

But as it jostles with the other vultures like hedge funds, PE has some enduring advantages which come from its distinctive forms of ownership. The credit crunch after summer 2007 inaugurated a period of deleveraging when lenders wanted their money back and the credit markets had stalled so new borrowing was expensive or impossible. If all that is nothing new in capitalist history, the downswing of this asset price cycle is different because it is the first to run under mark to market accounting conventions which require banks and other to take large write downs on the depreciating bad assets. But PE has locked in its investors for 10 years and is not caught in a vicious circle of mark to market write downs that undermine the share price. Ownership ensures that, on the downswing of the asset price cycle, PE is never a forced seller and has the funding to take advantage of distressed sellers.

While PE is vindicated by the way fixed ownership enables mobility, it is not unchallenged because experiment with ownership continues inside and outside PE. Some of the largest firms in PE, like KKR and Apollo Management claim to be planning listings, or at least issuing publicly traded shares and minority stakes, as Fortress Investment Group and Blackstone did in 2007. In the case of Blackstone's share issue, media commentators observed that this kind of move was inconsistent with Blackstone's previous rhetoric about the general disadvantages of listed status, especially for PE funds (Financial Times, 21 March 2007) and subsequently the move did upset some LP investors such as CalSTRS (Wall Street Journal Europe, 5-7 September 2008). The Financial Times (21 June 2007) then noted the sale of shares would net gains of about £2.6 billion for the two Blackstone principals Steve Schwarzman and Pete Petersen and reported the view that these GPs were near the cyclical peak, 'cashing in their chips, leaving public investors holding the cards'. The view was supported when less than a year later the Blackstone shares were trading at 50% below the IPO price (Financial Times, 11 March 2008). Apart from such predictable opportunism within PE, there is continuing experiment with other organisational forms including public companies. Thus, in September 2008 the financier Clive Cowdrey announced he was raising £1 billion for acquisitions in financial services and specifically for the break-up of financial conglomerates through a listed vehicle with a curious governance structure as the financiers would operate from a separate management company (Financial Times, 10 Sept 2008).

6. Resisting hierarchy through ownership

The challenge for cultural political economy is to understand the mobility and resourcefulness which secures capitalism's future at every conjunctural turn, and leaves its (social democratic) critics and (neo-liberal) champions wrong footed and struggling to catch up. From this point of view, it is certainly true that, one way or another, capitalism has been financialized for one hundred years or more. But our present day financialized capitalism, or at least the version current in the period up to the 2008 crash, is one of mass investors and mobile elites all chasing alpha from the 'new, new thing'. And that is very different from the rentier financialized capitalism of the pre-1914 period which was dominated by banks and insurance companies with finance supporting production and tracking trade flows. If the differences in frame, conjuncture and activity are considerable, one crucial aspect of that change is the reworking of capitalist hierarchy as new processes of financialization both create new elite positions and drive new inequalities of income and wealth (Savage and Williams, 2008).

The problem of capitalist hierarchy is about the relation between money rewards and positioning within a division of labour and ownership rights, not about why 'stars' earn inordinately high pay as in the 'winner takes all' theories by authors like Frank and Cook (1996). A generation ago, the capitalist problem was tackled in a brilliantly insightful and theoretically antediluvian conjecture by Marglin (1974). After resisting Smith's economic

argument about how the division of labour in pin making allows productivity gains, Marglin offers a political argument about how the division of labour in textile production benefits the putter out who gains distributively. Marglin argues that this division of labour is endogenous and resistable but nevertheless stable because the gain from reintegration is only a labourer's wage. Marglin's insight can be transposed in a variety of ways to understand the position and rewards of the financial elites in present day capitalism without buying into Marglin's Marxist supposition about a supposedly (pre-existing) class interest in accumulation. Thus, the French sociologist Olivier Godechot (2008: 145-61) has argued that, with upscaling in derivatives trading, the head of the dealing room can create a political division of labour from which he benefits because, like the putter out, only the head of the dealing room holds the whole business in his head. In the same way, we have marshalled argument and evidence about how the general partner in private equity creates a political division of ownership from which he benefits by positioning himself at the apex of a pyramid of claims. By implication, the political division of ownership is stable because the alternative for a limited partner like a pension fund is to invest more of the fund in PLC shares with mediocre returns. But this is not the expression of pre-existing class interest insofar as the new intermediaries are not a class but a 'distributive coalition' (Savage and Williams, 2008: 12-14) whose acquisitive behaviour involves bricolage and conjunctural opportunism (Engelen et al, 2008).

While the outcomes and implications of the 2008 crash are uncertain, as we have argued, the PE forms of ownership are well adapted to the disorderly period of interregnum between conjunctures so that general partners are well placed to reinvent themselves for the new conjuncture. While some circulation and re-ordering of elites is inevitable as conjunctures change, the invention of private equity has apparently created a new elite which adapts to economic events and is also remarkably politically resilient. In an important paper on the outcome of the 'mediated scandal' about private equity in the UK in the first half of 2007, Montgomerie et al, (2008) note that PE was poorly organised and lost the public argument battles, but then won the regulatory war to retain most of its tax concessions. From this point of view, the analysis of this paper is relevant because it shifts the basis for the critique of ownership from identity to position.

The trade union criticism of PE general partners (e.g. GMB, 2006) as asset strippers was just one phase in a series of intermittent popular and media panics about the sale of assets to foreign and/or new owners with supposedly dubious motives pre-given by their identity. Thus, after the panic about PE was over, Will Hutton (Observer, 7 September 2008) worried about whether the sale of British companies would encourage 'short-termism' and an absence of 'companies committed to the economic and social life of this country'. At the same time, in the USA as much as in the UK, there was unease about how commodity prices and trade imbalances were empowering sovereign wealth funds which already controlled \$3 trillion of US assets. Thus, Larry Summers the former Treasury secretary (BBC news web site, 24 January 2008) worried about the political motives of sovereign wealth funds and the extent to which they could deviate from the agenda of maximising risk adjusted rates of return. In all these cases, the suspicion is that a whole class of owners have motives or conduct rooted in their identity. Thus foreign PLC owners will reduce British operations to branch status, PE will asset strip and pillage labour and Sovereign Wealth Funds introduce political control motives. In a more restrained academic way, these assumptions about owner identity are echoed in much of the varieties of capitalism literature insofar as enterprise calculation is shaped by institutional complementarity and social compromise so that we would expect German firms to behave differently from US or UK firms (e.g. Albert, 1991; Hall and Soskice, 2001).

But here again the empirics hardly justify paranoia about the identity and motives of new owners. While confirming cases can of course be found, it is much more difficult to demonstrate that one class of owner is generally associated with styles of management or with distinctive outcomes. To that extent identity (as a matter of motive and result) is either

imaginary or its effects are overwhelmed by the variability of circumstance. And, in this case, demands for restrictions on selling assets and companies are predictably ineffectual in a world of liberalised capital movement and globalised firms. In which case, it might be better to start by objecting not to the supposed identity of owners but to their actual position. In the case of PE, the issue is surely not behavioural propensity to strip assets and labour but the general partner's organisation of a hierarchy of claims. Adverse judgement on that hierarchy depends only on understanding the general logic of the political division of ownership and providing some corroborating empirics on how it works in different cases. If all general partners (regardless of motive or result) position themselves in this way to claim cash by redistribution (from limited partners and purchasers of debt) then the policy response should be to discourage such positioning. If it is not possible to limit financier access to the partnership form or change the tax treatment of interest payments, then the political division of ownership argument suggests that the PE business should be made less attractive by taxing general partner gains (particularly the carry) at much higher rates.

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